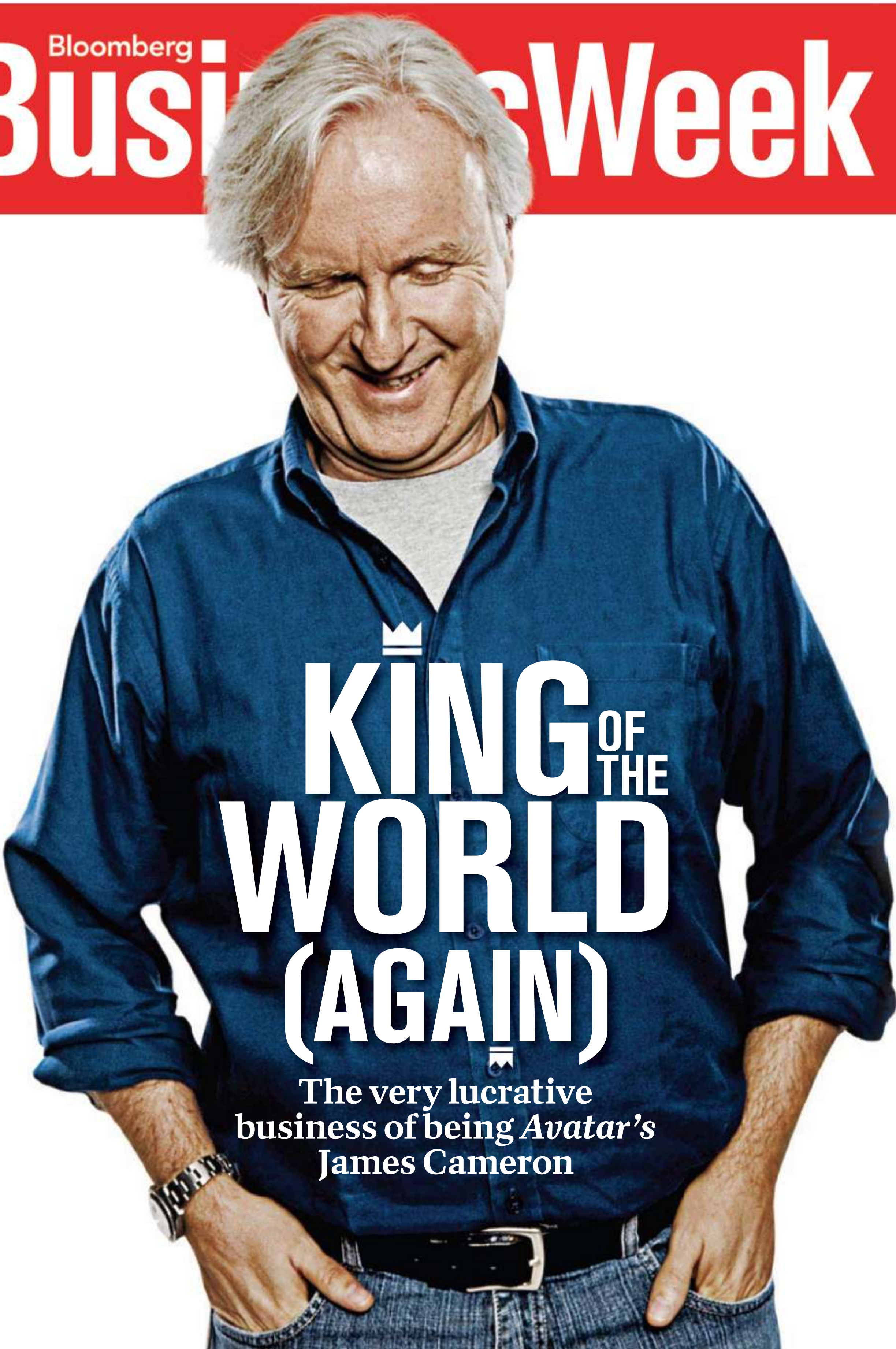
SPECIAL DOUBLE ISSUE

FEBRUARY 1 & 8, 2010 | BUSINESSWEEK.COM

OBAMA'S YEAR TWO: TIME TO START OVER

Bloomberg BusinessWeek



KING OF THE WORLD (AGAIN)

The very lucrative business of being *Avatar's* James Cameron

Smarter business for a Smarter Planet:

What if foresight were 20/20?

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In year two, Obama faces 10% unemployment and a deficit nearly equal to 10% of the economy

(COVER) PHOTOGRAPH BY MICHAEL MULLER/CONTOUR BY GETTY IMAGES; (ABOVE) KEVIN LAMARQUE/REUTERS

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Bloomberg BusinessWeek

The Global Report



Prince Alwaleed: A bank tax is "premature"

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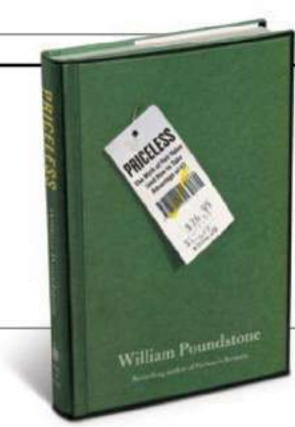
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THE WEEK IN BUSINESS



LEADERSHIP

MASSACHUSETTS SHOCKER

It wasn't even close. **Scott Brown,** a Republican state senator, surged to victory on Jan. 19 with 52% of the vote to **Martha Coakley's** 47% in the race to fill the Senate seat of the late **Ted Kennedy.** Brown's win deprives the Democrats of the 60 votes necessary to quash a filibuster, thus placing the health-care reform bill and other pieces of key legislation, such as the financial regulatory overhaul and carbon emissions cap-and-trade, in jeopardy. The upset reverberated with other worrisome messages for the Democrats. **President Obama,** who campaigned for Coakley in the final weekend, appears to have lost some of his electoral magic, and independent voters seem disillusioned with the Administration's performance thus far, presaging possible big gains for Republicans in this year's midterm elections.

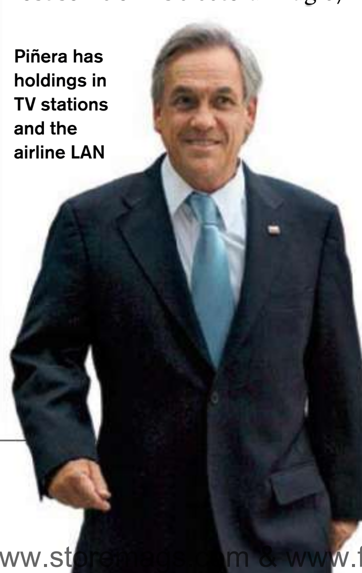
| BW | PAGE 020 "The Long Road Back From Massachusetts"

Brown's win bodes ill for the Democrats later this year

11%

Increase in U.S. building permits issued in December, the biggest jump since June 2008

Data: Commerce Dept.



Piñera has holdings in TV stations and the airline LAN

A BUSINESSMAN FOR CHILE

Like **Italian Prime Minister Silvio Berlusconi, Sebastián Piñera,** the President-elect of Chile, is a billionaire TV magnate who must unload major business interests before taking office on Mar. 11. Piñera, 60, a former Citibank executive who built his fortune by introduc-

(TOP) ADAM HUNGER/REUTERS; (BOTTOM) VICTOR ROJAS/DPA

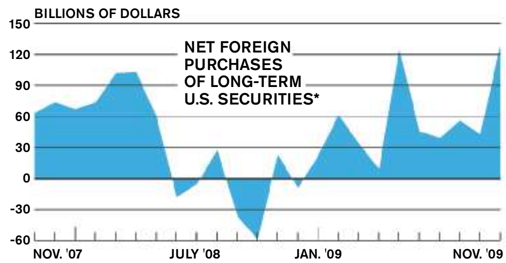
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EXECUTIVE SUMMARY

ing **MasterCard** and **Visa** to Chile in the 1980s, was elected on Jan. 17. Three days later he started selling his 26% stake in **LAN,** Latin America's largest airline, worth around $1.5 billion. The President-elect will hold on to other investments, including a Chilean TV network and stakes in the country's top soccer team and an upscale hospital, which are in blind trusts. The conservative Piñera spent at least $13.6 million to win the vote, unseating a center-left coalition that had ruled Chile for two decades.

BUY AMERICAN

International demand for U.S. long-term paper surged in November



*INCLUDES STOCKS, BONDS, AND GOVERNMENT SECURITIES.

Data: U.S. Treasury.

STRATEGY

JAL'S BUMPY LANDING

Japan Airlines, Asia's top carrier and onetime proud emblem of Japan's postwar expansion, filed for bankruptcy on Jan. 19 with liabilities of $25 billion. That makes the filing Japan's fourth-biggest ever. Under the terms, JAL will keep flying but will emerge much smaller. As part of the $10 billion turnaround plan, which includes $3.3 billion in funding from state-backed **Enterprise Turnaround Initiative Corp.,** it will lay off 15,700 employees—about 30% of the workforce—ground 53 planes, and cut 31 domestic and international routes. Despite its woes, **Delta Air Lines** and **American Airlines** have made rival offers to invest in JAL.

PAY UP, SAYS THE *TIMES*

For the past year, top management at *The New York Times* has debated print media's key conundrum: how to generate more revenue from online content without losing the volume of readers that makes the Web attractive to advertisers. On Jan. 20, **Publisher Arthur Sulzberger Jr.** announced that, in 2011, the *Times* will restrict the number of articles that Web surfers can view for free. The paper didn't release any details on pricing or what the threshhold would be before a purchase request appears, saying only that the new model would "provide the necessary flexibility to keep an appropriate ratio between free and paid content and stay connected to a search-driven Web." The Gray Lady's previous attempt to charge for online content, called **Times Select,** was abandoned in 2007.

CONAN: TO BE CONTINUED

The late-night snarl at **NBC** is gradually sorting itself out, with a newly magnanimous **Jay Leno** calling *Tonight Show* host **Conan O'Brien** "a good guy"—while O'Brien compared NBC to a toilet bowl. O'Brien, who along with his staff will collect an estimated $40 million in severance while relinquishing the show and 11:35 time slot to Leno, isn't expected to be off the air for long; Fox programming executives covet the 46-year-old comedian for his appeal with younger viewers. Leno, meanwhile, could return to his former gig as early as Jan. 22, two weeks sooner than NBC had originally proposed. The good news for Conan: Rallies around the country have helped boost his ratings. The question is whether Leno—whose swoon at 10 p.m. angered local affiliates, which in turn pressured NBC to make a move—can recapture his ratings glow when he takes his seat after the 11 o'clock news.

A BIG ROCK CANDY DEAL

Cadbury isn't exactly sweet on **Kraft,** but after four months of resistance, the British chocolatier finally succumbed. Kraft had to boost its initial cash-and-stock bid by 9%, to $19.4 billion, and pledge to pay a onetime dividend once the offer is approved. But Cadbury proved unable to lure a competing bid from other possible suitors such as **Hershey's** or **Nestlé.** The purchase will continue the consolidation of Big Candy, turning Kraft into the world's largest confectioner, with $50 billion in sales and

Cadbury Creme Eggs get hatched: The company accepted Kraft's revised offer



PHOTOGRAPH BY CHRISTOPHER FURLONG/GETTY IMAGES; CHART BY STANFORD KAY

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EXECUTIVE SUMMARY



A support banner in Hong Kong: Google will delay the launch of its phones in China

operations across Europe, Asia, and the Americas.

TECHNOLOGY

GOOGLE, YAHOO!, AND CHINA

Following Google's announcement that it will no longer censor its search results in China, the company sent another signal of impatience to Beijing by delaying indefinitely the China launch of two phones using its **Android** operating system. Yahoo, one of the few technology giants to support Google's stance on China, was meanwhile attacked as "reckless" by its Chinese e-commerce partner, **Alibaba.** Yahoo owns 39% of Alibaba but doesn't control the company.

⊵ "In China, Google Fallout Damages Yahoo!" businessweek.com/magazine

FINANCE

BANKS: STILL BRUISED

Fleeing the embrace of TARP cost banks dearly in the fourth quarter, turning profits into losses for two of the biggest firms. **Bank of America,** the leading U.S. lender, posted a $2.2 billion loss, its first red ink for a full year since 1987, because of an accounting charge incurred to repay the government's emergency investment. **Citigroup** lost $1.6 billion for the year, dragged down by an $8 billion charge to exit TARP. **Wells Fargo** managed to eke out a small fourth-quarter profit despite its TARP payback. Leading the earnings pack was **JPMorgan Chase,** which announced a handsome (for these times) profit of $11.7 billion on the year.

| BW | PAGE 012 "Everyone Wants a Piece of the Banks"

A BIG WEEK FOR HIGH YIELD

Investors are hungry for junk. Companies sold $11.7 billion in high-yield bonds in the week ended Jan. 15, the largest amount on record, *The Wall Street Journal* noted. The risky deals eerily evoke the boom, suggesting that investors have already stifled their memories of 2009, when 11% of high-yield issuers fell into default. Private-equity backed companies are using junk-bond proceeds to pay a dividend to their owners. And plungers in search of high returns don't seem to mind giving up protection; some of the new junk bonds lack covenants that require companies to maintain certain liquidity levels and meet operational targets.

ECONOMICS & POLICY

DID J&J GO ASTRAY?

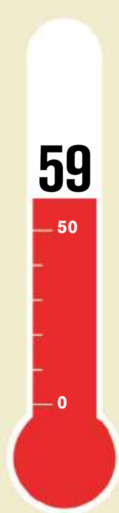
J&J CEO William Weldon: The company was accused of paying kickbacks



Whistleblowers strike again: The **Justice Dept.** filed a civil complaint on Jan. 15 against **Johnson & Johnson** and two subsidiaries, alleging that they paid kickbacks to **Omnicare** from 1999 to 2004 to push prescriptions for J&J drugs, especially the antipsychotic **Risperdal.** The feds joined lawsuits brought by two former Omnicare staffers under the federal **False Claims Act.** In November, Omnicare, the largest U.S. pharmacy for nursing home patients, agreed to pay $98 million to settle civil allegations that it took such kickbacks from J&J. Omnicare didn't admit any wrongdoing. In response to the Justice Dept. suit, a company spokesman said J&J's conduct was "lawful and appropriate."

THE OPTIMISM METER

A SUNNIER OUTLOOK



The Meter topped 59, a two-month high, on Jan. 19, as economists raised their 2010 gross domestic product growth forecast to an average of 2.7%. Developed by ***Bloomberg BusinessWeek*** using data from pollster **YouGov,** the Meter is a proprietary measure of sentiment and expectations, economic statistics, and market forecasts. It evaluates shifts in outlook among individuals, professional investors, and economists in the areas of U.S. economic growth, jobs, equity markets, and real estate.

0=lowest and 100=highest

(TOP) JEROME FAVRE/BLOOMBERG; (BOTTOM) STEVE HOCKSTEIN/BLOOMBERG NEWS

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DYMO
practically genius

Genius vs. Practically Genius





While some genius often fosters revolutionary change, here's to a celebration of everyday genius. Useful genius. Functional genius. Genius that isn't quite world changing, but still elicits that "Aha!" moment when you discover a more practical way to get something done. Now that's Practically Genius.

And that's the theme of a new branding campaign from DYMO. A campaign featuring innovative products designed to make the everyday a little easier — including DYMO® LabelWriter® printers and LabelManager® electronic label makers, Rhino industrial label printers, CardScan® contact management solutions, Endicia Internet mailing solutions and mimio® interactive teaching technologies.

THERE'S GOT TO BE A BETTER WAY

"Every product in the DYMO lineup was born from the idea that 'There's got to be a better way,'" says Bob Kibbe, President of DYMO. "Practically Genius perfectly articulates that brand philosophy, as DYMO continues to focus on innovations to improve the ease — and quality — of everyday tasks."

While Practically Genius is a fresh new brand expression, DYMO is no marketplace newcomer. Since being founded over 50 years ago, DYMO has grown into a global brand and a recognized leader in technology solutions for the home, office, warehouse, worksite and classroom.

A recent addition to the DYMO family is its line of LabelWriter 450 printers, providing high-speed label and postage printing directly from a PC or Mac.® Talk about Practically Genius — you'll never run out for stamps again!

PRACTICALLY GENIUS IN ACTION

Calvin Edwards, Jr., a trial attorney for more than 10 years, is reaping the Practically Genius benefits of DYMO. Calvin handles many complicated cases, making case file organization vital. In searching for an efficient, easy-to-use labeling system, Calvin opted for the LabelWriter 450 Twin Turbo.

"Our files are now always well organized with little effort required by my staff," says Calvin. "We also cut down the time required for our firm mailings by 35% with the LabelWriter's postage feature."

What's more, the LabelWriter 450 Twin Turbo has helped Calvin organize his files so well that he no longer needs his firm's management software.

As Bob Kibbe sees it, "Practically Genius" is more than a slogan for DYMO; it also describes the people who use the products. "When our customers sometimes turn mundane tasks into opportunities to strive for excellence — whether it is realizing more cost savings or greater efficiency — we hope that they can feel a little genius, too."

For more information about DYMO and its complete line of office solutions, please visit **www.dymo.com.**

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BUSINESS OUTLOOK | MICHAEL McKEE

AS THE ECONOMY RECOVERS, WHAT IS 'NORMAL'?

The Great Recession had many experts fretting about America's long-term growth potential. Now a survey of Wall Street economists shows a less pessimistic view.

The "new normal" may not be the new norm after all. At least that's the belief of many Wall Street economists, who aren't buying the theory advanced by Bill Gross and Mohamed El-Erian, co-chief investment officers at Pacific Investment Management Co. (Pimco), that the U.S. will be stuck in long-term sluggish growth averaging 2% a year. Instead, the median forecast of 46 economists surveyed by Bloomberg is for potential real growth, or the rate of economic expansion at which inflation is steady, of 2.5%, matching the average rate of the past 20 years.

While the half-percentage point between Pimco's projection and the survey median may seem small, it makes a big difference over time, especially to investors. Expanding by 2.5% a year rather than 2% would leave the $13 trillion U.S. economy larger five years from now by almost an extra $400 billion, about equal to the gross domestic product of Argentina.

2.5%

Median forecast for the U.S. economy's potential long-term growth rate

Data: Bloomberg News survey

Such growth would also likely translate into higher corporate sales and earnings. Kevin Gardiner, head of investment strategy at Barclays Wealth, says returns on equities historically have been about 7%. "They'll likely be above that for some period," he says. That would be a far healthier performance than the 5% forecast by Pimco, manager of the world's biggest bond fund.

Investors have been betting on that more optimistic outlook. The Standard & Poor's 500-stock index is up 27% since early May, when Gross and El-Erian made their forecast. Government policymakers are hoping for a return to the historical trend, as well. That's because a new normal growth rate would be particularly bad news for President Barack Obama's Administration and Congress as they cope with a budget deficit projected to reach $1.4 trillion in the current fiscal year. Faster growth means higher tax revenue, making it easier to close that shortfall.

The economy was still bumping along the sea floor last spring when the Pimco executives said an extended period of greater government regulation and lower consumer spending would stunt growth for years. Gross domestic product had contracted 6.4% in the first quarter of 2009, and unemployment had just hit a 26-year high.

But while the jobless rate continued to climb, peaking at 10.1% in October, the $787 billion federal stimulus program that took effect in February helped the economy begin expanding in the third quarter at a 2.2% annual rate. And fourth-quarter GDP is on track to rise 5.6%, according to forecaster Macroeconomic Advisers.

The major reason: Companies that drew down stockpiles during the recession are restocking to meet increased demand. Business inventories rose 0.4% in November for a second month after 13 months of decline.

But El-Erian says the turnaround is only temporary. "After an inventory-driven bounce in the GDP growth rate, we are expecting a 2% annual pace," he says. "It will take years for the U.S. economy to recover to the level of GDP attained before the crisis."

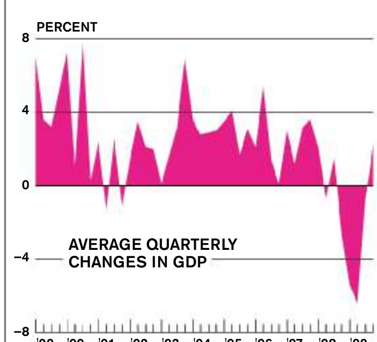
Some on Wall Street share that pessimism. Drew Matus, a senior economist at Bank of America Merrill Lynch, predicts the U.S. will experience faster growth as the recovery builds, but the pace will then slow.

His company sees potential growth of 2.25%, "not substantively different" from Pimco, and down from a 2.75% estimate before the recession began in December 2007. "When people talk about the new normal, they're not talking about 2010 or 2011, they're talking 2013 and beyond," says Matus.

While Stephen Stanley, chief economist at RBS Securities, has also trimmed his growth estimate, to 2.6% from 2.75%, he rejects the idea that the economy is permanently different. That's because he figures potential growth comes from increases in productivity and in the labor force, which rises with the population, and "the business cycle doesn't change that."

Robert MacIntosh, chief economist at Eaton Vance Management, is even more optimistic. He pegs long-term expansion at a robust 3.75%, but for a more basic reason. Explains MacIntosh: "We're still Americans, and we're still going to consume." |BW|

LONG-TERM U.S. GROWTH HAS BEEN CHOPPY



Data: Bloomberg

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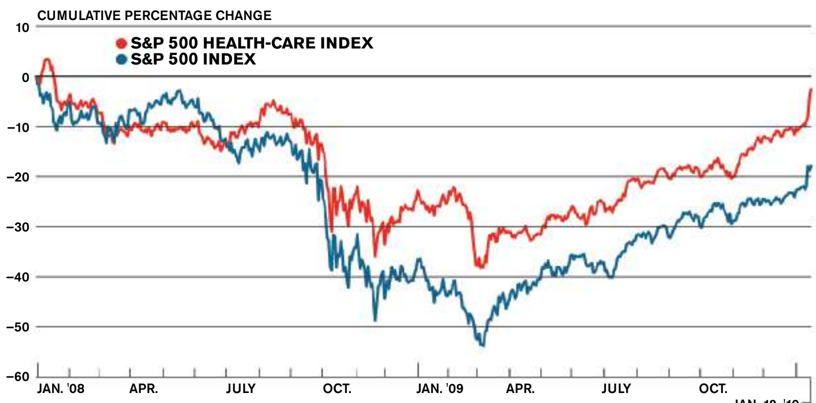
NUMBERS

YES, THE HEALTH-CARE BUSINESS IS RECESSION-PROOF

By Tara Kalwarski/Charts by David Foster

Health-care companies in the Standard & Poor's 500-stock index held up better than the overall market during the crash. In fact, many industry execs think the recession helped them. No wonder: Profit margins mostly rose, and the earnings outlook is good.

Nearly Full Recovery: Health-care shares are approaching their two-year highs.



Data: Bloomberg

Power Players: Big U.S. health-care companies are expected to do well in 2010, too.

2010 FORECAST FOR LARGE U.S. HEALTH-CARE COMPANIES

	EARNINGS GROWTH	PROFIT MARGIN
Pfizer	11%	31%
Merck	6%	31%
Abbott Laboratories	12%	22%
Amgen	2%	36%
Medtronic	10%	26%

Data: Bloomberg

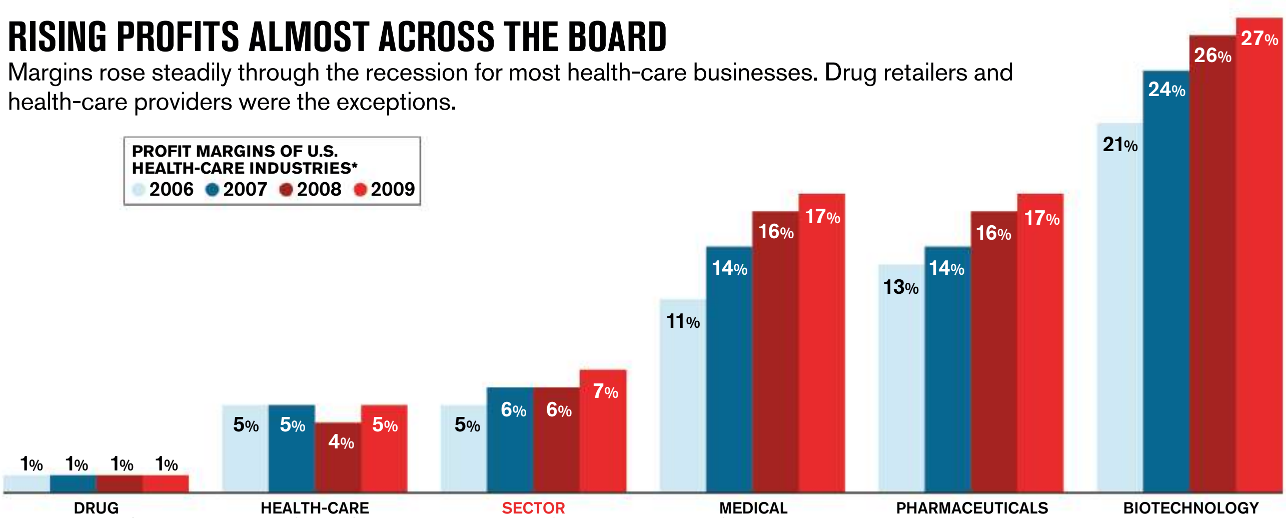
10 of 27

Number of senior U.S. health-care executives who said the recession helped their industry. Only 4 of the 27 said it hurt.*

*Survey conducted in June 2009 Data: Aite

RISING PROFITS ALMOST ACROSS THE BOARD

Margins rose steadily through the recession for most health-care businesses. Drug retailers and health-care providers were the exceptions.

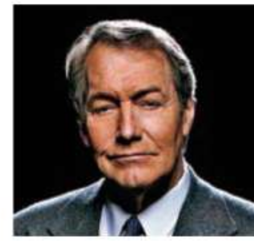


*Calculated by dividing calendar year net income by revenue, for the companies in the S&P 500 Health-Care Index

Data: Bloomberg

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AT THE TABLE CHARLIE ROSE



PRINCE ALWALEED BIN TALAL
On Citi, Murdoch, and terrorism

Prince Alwaleed bin Talal is chairman of Kingdom Holding Co., a Saudi firm with billions invested around the globe. He is ranked among the 25 wealthiest people in the world and is the largest single investor in embattled Citigroup, which just posted a $7.6 billion net loss for the fourth quarter. It is said that his displeasure with another Prince, Chuck Prince, contributed to the ouster of the Citi CEO in late 2007. The economic crisis has taken a toll on Prince Alwaleed's holdings, and he recently injected nearly $600 million of his personal wealth into his firm after a year of steep losses. He is a nephew of King Abdullah of Saudi Arabia and one of the most outspoken members of the royal family. I talked with the prince on Jan. 15.



Prince Alwaleed says a new tax on banks would be "premature and unwarranted"

CHARLIE ROSE

How do you see the global economic recovery?

PRINCE ALWALEED BIN TALAL

The decline has stopped. The question now is, will there be an L-shaped or V-shaped recovery? I hope that the L will be at least a U.

You just saw Vikram Pandit and Richard Parsons, and you're confident that Citigroup is back on the road ... to what?

We had a very healthy discussion about the past two years and what Vikram inherited from the previous management. If you follow what he has been doing, he has been extremely meticulous, and he has been delivering on all his promises. But I'm telling him, you have to deliver in 2010.

What's your reaction to President Obama's plan to impose a tax on banks?

I'm against that. The banks, with a few exceptions, have gone through major crises. So while these banks are just coming out of the ICU, you bang them with another tax? I believe it's premature and unwarranted ... and more of a vendetta against those banks that are still giving extravagant bonuses to their management.

You're a huge investor in News Corp. Are you confident about its future?

I'm the second-biggest shareholder there. I was with Mr. Murdoch yesterday and have a very close relationship with Mr. James Murdoch. James is now

(FROM TOP) PHOTOGRAPHS BY BRAD TRENT; FRANCO PAGETTI/VII

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managing Europe and Asia. I would be the first one to nominate him to be the successor of Mr. Rupert Murdoch, God forbid something happens. I have full trust in him. He is really a Rupert Murdoch in the making, and he's almost there. And I told that to Mr. Murdoch.

Have you seen the Fox movie *Avatar*?
I had to see it before I met Mr. Murdoch. If I didn't, he would be upset.

Did you like it?
Well, it was the first time I've seen a science fiction movie. What I like is the fact that people like it and it will gross more than $2 billion and could possibly add $400 million to the bottom line of News Corp. Imagine that. Whether I like it or not I will keep between me and Mr. Murdoch.

What do you think of America and our future?
America is down but not out. You know, you are in a mess in the United States. I have to be honest with you because I love the United States.

And you are heavily invested here.
Yes, sir. You know, the United States is going to be the leader of the world for many years to come. But when you have a country that has $14 trillion of cumulative debt, that's not good.

So what should happen?
I'm not the U.S. President ... but taxes have to be raised across the board.

It's a hard political sell in America.
I understand, very dangerous. I see no way out, though. You're going to have to pay the debt, eventually.

So what do you worry about?
Clearly, the biggest worry right now for every human being in the world is terrorism.

When you look at Iraq and Afghanistan, do you worry about the possibilities of things going wrong?
Iraq is a time bomb. Afghanistan is a time bomb. Pakistan is also a time bomb. But Afghanistan is where the real threat is. This country could implode.

You know the President of Syria, Bashar al-Assad, well. Does Syria intend to play a positive role in the peace process between the Palestinians and the Israelis?
My friend Bashar al-Assad wants the Palestinians to live in peace with Israel. I can assure you that Bashar is going to play a very big role in getting the peace process moving.



James Murdoch: The prince calls him "a Rupert Murdoch in the making"

MURDO MACLEOD/POLARIS

What stands between an accord between Syria and Israel?
A small piece of land—the Golan Heights. It's very technical and could be resolved if there is a will from the Israelis. Bashar just wants his land back, period. The Golan is Syrian.

What is your assessment of the possibility of something happening between Israel and the Palestinians?
I believe the Middle East is the core problem. The terrorist acts and all these things are really side effects. [The situation] needs to be resolved as soon as possible. I think that if Israel wants to have peace, they can have peace within a month or two ... to be honest with you.

But just last week there was some shelling from Gaza into Israel.
Israel is a dominant force in Middle East. We all know that it has the biggest military. It has nuclear bombs. So Israel is untouchable. Now, if Israel can get its house in order and have ...

What do you mean by get its house in order?
The Netanyahu government does not want to have peace with the Palestinians.

So your answer to the conflict in the Middle East between the Israelis and the Palestinians is that the United States must pressure the Israelis to do more? That's your answer?
That's right, because all the power is in the hands of Israel. They have the land in their possession. They have Jerusalem in their possession. Everything is in their hands.

What should be done about Iran?
I think the United States has to take a very firm position against Iran ... really just box them in and give them an ultimatum. Right now what's happening in Iran reminds us of the pre-revolution era of the shah.

Will Ahmadinejad survive?
The way he's handling his opponents is really very savage. We don't know how this thing is going to end. But at this stage, you must engage with Ahmadinejad until we see what happens.

Do you think the world's perception of Islam is misunderstood?
Oh, yes, for sure. After 9/11, the world changed, and Islam came under attack. You had all these terrorist acts on U.S. soil committed by Muslims and Arabs and Saudis. So I don't really blame the West for being worried about Islam. But you cannot generalize and say all Arabs or Muslims are terrorists. All the discussion has been around the Somali guy who tried to bomb the [Northwest] airplane, but his father ...

... Turned him in.
This guy represents Islam. He went to the U.S. Embassy and said, "My son is a terrorist in the making. Please take care of him." This guy represents me and all my 1.3 billion Muslims. Not the guy with the bomb. Islam means peace. That's the irony of it. |BW|

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Everyone Wants a Piece of the Banks

Shareholders are clamoring for higher dividends. Borrowers want more loans. And the Obama Administration is trying to levy a new tax

By Peter Coy

They say you can never be too rich or too thin. But too safe? Apparently that can be a problem. In an earnings call with analysts in January, JPMorgan Chase CEO Jamie Dimon said that the way things are going now, many banks will be "overcapitalized" by mid- to late-2010. As banks have increased profits, or sold shares and hoarded cash on regulators' orders, their safety margins have substantially exceeded regulatory minimums. Now they are coming under pressure from various fronts to surrender some of that cushion—and shareholders, pushing for fatter dividends, may have the best chance of getting their hands on the money.

Overcapitalization may sound like a good problem to have, considering that only a year or so ago the federal government was racing to save the U.S. financial system from outright collapse. Surprisingly, though, having too much money can be almost as bothersome as not having enough. Pressures on Dimon and other bank CEOs are mounting from multiple directions: from shareholders who want bigger payouts; small businesses that say the banks should make more loans to revive the economy; employees who want bigger bonuses; and the Obama Administration, which wants to tax big banks to cover the government's $117 billion in projected losses from the bailout.

Of all the competing claims, shareholders' demands for higher dividends may be the most likely to succeed. JPMorgan Chase, regarded as the best managed of the large banks, will probably be the first to hike payments. In the call discussing the bank's $3.3 billion fourth-quarter profit, JPMorgan Chase reiterated plans to raise the annual dividend, now 20¢ a share, to 75¢ or $1 in the second half of this year, assuming the economy continues to recover and loan losses are in line with expectations. Says Matthew D. McCormick, a portfolio manager and banking analyst at Bahl & Gaynor Investment Counsel in Cincinnati: "If you can be the first bank to increase the dividend, that's going to make a statement to the investing public."

Shareholders can make a strong case for the money. The average dividend yield of big banks—that is, the dividend divided by the stock price—is at its lowest since 1997. Federal regulators understand that banks need to reward shareholders so they'll be willing to buy future issues and build

A TUG-OF-WAR OVER PROFITS

There are plenty of conflicting opinions on what banks should do with the money they're making

WHO	WHAT THEY WANT
Executives	Higher salaries and bonuses
Shareholders	Bigger dividends
Regulators	High capital levels
Borrowers	More lending
White House	Tax on the biggest banks

Data: *Bloomberg BusinessWeek*

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BRIAN STAUFFER

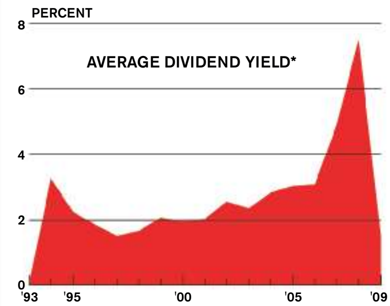
up the companies' capital base. It's a fine line on how tough to get on limiting dividend hikes, says one federal regulator who asked not to be named, adding it's going to be challenging to get the balance right.

The financial institutions don't plan on emptying out their treasuries to pay for higher dividends. Dimon, for one, is intent on keeping JPMorgan Chase well-capitalized. He says regulatory minimums for capital are going to be raised in the next few years. "No one wants to be caught short in capital, particularly if someone is going to be punitive about it," Dimon told analysts. Higher payouts will come at a cost. Each dollar paid out in dividends is a dollar not available for fresh lending or covering surprise losses on loans.

An increase by JPMorgan Chase will pressure other banks to raise their divi-

PUNY PAYOUTS

Dividend yields are at their lowest level in more than a decade



Data: Bloomberg *KBW Bank Index

dends, even though their finances may not be as sturdy. While U.S. Bancorp and BB&T may also hike their payouts this year, according to analyst Jason M. Goldberg of Barclays Capital, Citigroup and Bank of America probably won't be able to do so until at least 2011. (Spokesmen for Bank of America, Citigroup, and Wells Fargo declined to comment on their plans.)

An abundance of capital by itself is no guarantee of health. By one measure, Citi's capital amounts to 11.7% of assets, more than JPMorgan Chase's 11.1% and well above the 6% regulatory minimum. But no one would argue that Citi is in good shape. It reported a $7.6 billion fourth-quarter loss this month, and CEO Vikram Pandit faces continued high default rates on his loan portfolio. (A spokesman for the Office of the Comptroller of the Currency says its examiners don't rely solely on banks' capital ratios to determine their soundness.) Before JPMorgan or any other bank boosts its dividend, it will have to get clearance from its overseers. Federal Reserve guidelines say regulators must consider "current and prospective earnings" as well as "prevailing market and economic conditions" when evaluating the request.

Some economists argue that even the strongest institutions should be conserving their cash, because a big decline in asset values could still leave them insolvent and in need of a taxpayer bailout. "We don't want big banks, even responsible big banks, to gamble with the taxpayers' chips," says

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Citi's Pandit has raised lots of capital but faces more loan losses

they do, pay could fall in tandem, says Alan Johnson, managing director of Johnson Associates, a New York-based compensation consultant.

Meanwhile, prospects for the Obama tax on banks are uncertain. The levy faces a possible constitutional challenge and accusations of unfairness. Warren Buffett opposes a tax. "This is not conducive to an investor-friendly environment," says Peter Sorrentino, who helps manage $13.8 billion at Huntington Asset Advisors in Cincinnati. A senior Obama Administration official says the White House is hoping the banks will take the money largely out of their bonus pools,

Boston University economist Laurence J. Kotlikoff. One reason for concern: Banks could still get smacked by losses on their vast portfolios of real estate loans, says Edward Casas, head of Navigant Capital Advisors, a corporate finance adviser in Skokie, Ill. One sign that the companies haven't fully recognized their losses, says Casas, is that they're reluctant to sell assets at the going market price. He says midsize and small transactions "are still basically frozen" because banks won't cut their asking prices enough.

The cash cushion highlights another dilemma: Should banks lend more money or should they be tougher about granting loans to limit the risk of defaults? Loans on banks' books fell from $7.3 trillion in October 2008 to just under $6.7 trillion in early January 2010. Politicians have demanded that institutions step up lending to help lift the economy. Presumably banks would like to comply, since that's how they make their money. The $1 trillion they have stashed at the Federal Reserve earns just 0.25% a year.

The main reason for the decline in lending is that the recession has turned some would-be borrowers into bad risks and suppressed demand for credit from others. The National Federation of Independent Business says that in December only 8% of its small-business members reported they had credit needs that weren't satisfied, vs. about 5% who say so when credit is flush.

But some banks may have dialed back too far. In Denver entrepreneurs Frank Alfonso and Bill Cossoff had to get their local congressman's help to land a loan to open a third Big Papa's BBQ restaurant. In Los Angeles, Lourdes Sobrino says she was turned down by 15 or more banks for a $500,000 loan to relocate her Mexican-style Lulu's Dessert business, which employs 45 people. Facing a Jan. 22 deadline to vacate her current premises, she was seeking outside investors instead. Her problem: The 28-year-old company lost money in 2009. "I've had loans all my business life," says Sobrino. "I paid all of them successfully. The banks say, 'We're very conservative.' ... Honestly, they don't care."

The other people grabbing for a piece of the banks' stash are the bankers themselves, who want higher salaries and bonuses. At JPMorgan, average pay at the investment bank rose 37% last year. But industry earnings may well fall in 2010, and if

but that would not be required.

In short, lots of people want to get their hands on the money of those "overcapitalized" banks. But at the moment, it looks like shareholders will be getting first dibs. |BW|

With Bradley Keoun, Elizabeth Hester, David Mildenberg, and Jane Sasseen

Business Exchange

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The Big Number

Everyone from Wall Street to Washington is fixated on the final tally for bank bonuses, says a Jan. 10 article in *The New York Times*. Some executives and top performers may get eight-figure sums this year. While many banks are handing out stock awards instead of just cash, the move may not be enough to placate the public. "The debate has shifted in the last nine months or so from just 'less cash, more stock' to 'what's the overall number?'" said Robert P. Kelly, chief executive of the Bank of New York Mellon.

To read the full piece, go to http://bx.businessweek.com/financial-services-industry/reference/

DANIEL ACKER/BLOOMBERG NEWS

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Home Is Where the Private Equity Is

Opportunistic investors are backing strapped builders—and risky as it is, the strategy may pay off

By John Gittelsohn

Their love affair with traditional lenders is on the rocks, so some residential real estate developers have found a new partner: private equity. More than 20 firms are looking to team up with homebuilders to go bargain shopping for distressed properties.

For developers, private equity firms bring much-needed cash. For investors, it's a classic contrarian play, adding new homes to a market flooded with inventory. That would be a doomed strategy if pursued on a large scale, but analysts believe a few well-chosen projects could pay off. "I've been getting the question: Why aren't housing starts at zero?" says Megan McGrath, an industry analyst with Barclays Capital in New York. "The answer is they're probably as close to zero as they're going to get, and in some cases it still makes sense to build."

Smelling opportunity, private equity managers raised at least $12 billion in 2009 for development projects and other residential real estate deals, according to an analysis by *Bloomberg BusinessWeek*. And some older funds are just putting their money to work. Last year Hovnanian Enterprises, the seventh-largest U.S. homebuilder by revenue, announced joint ventures with two New York private equity firms in which the investors put up 80% or more of the money. GoldenTree Asset Management joined Hovnanian for 11 projects around Chicago and Palm Beach, Fla.; Angelo Gordon & Co. signed on for other Florida deals. "For every [private equity firm] that we're doing business with, there are 10 more that we're talking to," Ara K. Hovnanian, the builder's CEO, told an industry conference in November.

It takes plenty of courage to bet on housing these days. The inventory of new homes, which had steadily fallen throughout much of 2009, began creeping up at the end of the year. It would now take 7.9 months to work through the supply, compared with a five-year average of 7.2 months. With unemployment and foreclosures still at quarter-century highs, demand could remain weak for some time, especially with federal tax incentives for home buyers set to phase out in April.

That's why investors say they're being picky about projects. A $100 million fund begun in 2007 by the U.K.'s Grosvenor and Cleveland's KeyBank took two years to make its first investment. The fund managers wanted to buy ready-to-build lots from troubled builders for about 20¢ on the dollar and hoped to avoid ugly markets such as Las Vegas, South Florida, and Southern California. So far, the fund has done five small deals for subdivisions, including ones outside Philadelphia and Raleigh, N.C.

Reuben S. Leibowitz, managing director of JEN Partners, a New York private equity fund, said he invested $50 million last year in land and construction deals in Southern California and Arizona, where he believes buyers are coming back. In May he bought Canta Mia, a 600-home senior community outside Phoenix, and hired local builder Carl Mulac to run the project. The original developer, Tousa, filed for bankruptcy, and Leibowitz acquired the project—complete with model homes—for less than the cost of putting in roads, waterlines, and other essentials. Leibowitz expects to recoup in four to seven years, but he says he doesn't see a lot of other good deals out there.

$113 billion

The amount of bank loans for land and new development in September 2009, down 44% from the year before

Data: Federal Deposit Insurance Corp.

At least one private equity fund has pulled up stakes. In 2006, Rockpoint Group, a Boston firm, raised $470 million from investors, including the California State Teachers' Retirement System, for a residential real estate fund. Rockpoint closed the portfolio in August—because it couldn't find enough workable deals. BW



Builder Mulac is working with a fund on a senior community outside Phoenix

BRENDAN MOORE

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Cocaine seized in Colombia, which produces 90% of the drug that flows to the U.S.

Marxists with a Better Business Plan

The Colombian guerrilla army FARC is raking in billions by directly supplying cocaine to Mexican drug cartels

By Bloomberg News

Eliminate the middleman: It's a time-honored strategy for maximizing profit.

According to a document captured by Colombian military intelligence, the Revolutionary Armed Forces of Colombia (FARC)—the South American nation's biggest guerrilla army—negotiated a deal in 2007 to supply Mexican drug cartels directly on consignment, bypassing the gangs that had previously served as go-betweens.

Under the pact, the FARC undertook to provide a kind of vendor financing for shipments of tons of cocaine, in essence taking on more risk in search of higher margins. The flood of cash that has since flowed to the guerrillas has helped them remain a threat to the government of President Alvaro Uribe and has offset the damage to their finances inflicted by a seven-year army offensive. "I've heard the FARC derives somewhere between $1 billion and $2 billion a year from the trade," says Michael Braun, who stepped down in 2008 as the U.S. Drug Enforcement Administration's operations chief. "I happen to believe that number is woefully underestimated."

The FARC, a Marxist group, has been fighting to topple Colombia's government for 45 years, making it the oldest guerrilla force in Latin America. More than a decade ago it began to finance its operations with cocaine sales and has since become the world's biggest producer. Colombia supplies more than 90% of the cocaine that enters the U.S., according to the White House Office of National Drug Control Policy. The U.S. Justice Dept. estimates that $17.2 billion worth of illegal drugs enters the U.S. from Mexico every year.

The meeting that laid out the new economics of the trade took place in the jungle hideout of Raúl Reyes, then the second-in-command on the FARC's seven-man executive committee, according to Colombia's National Defense Ministry. Reyes, then 58, described the meeting in a one-page letter dated Aug. 4, 2007, that was obtained by Bloomberg News. He was looking for new ways for the FARC to do business after Uribe's military offensive pushed the guerrillas into remote areas, sapping their revenue from extortion and kidnapping.

In the letter, Reyes reported that four months earlier a Colombian

FERNANDO VERGARA/AP PHOTO

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emissary from a Mexican cartel, identified as "Camilo," had come to his camp. Two high-level FARC comrades also attended the meeting. The discussion involved an initial deal for five tons of cocaine. "They are offering the FARC to take the product to Mexico and Europe," Reyes wrote in the letter, addressed to three other commanders. Each kilo sent to Mexico "costs $3,500 and it sells for $9,000. That's a profit of $5,500. For Europe, to send the product there and bring the money back, it will cost $15,000 and it sells for $30,000. The profit will be $15,000."

"DIRTY BOMB" CONNECTION

Reyes proposed to his comrades that the FARC "invest" 250 million Colombian pesos ($125,000) in shipping 100 kilos (220 pounds) of cocaine as a trial run, to be sold to the Mexicans for a profit of 700 million pesos "if all goes well." The FARC would reinvest half the profit and send an additional 140 kilos. Reinvestment of half the returns in new shipments would continue as long as "authorized" by the FARC's leadership, Reyes said.

According to a Colombian official who spoke on condition of anonymity, the agreement has given the FARC an opportunity to double its profit. But Reyes' role ended seven months after the jungle meeting, when Colombian troops killed him during a raid on his camp just over the Ecuadorean border. Colombian investigators, who provided the letter to Bloomberg News, pulled documents from Reyes' computers. The documents were later authenticated by Interpol, the international police agency.

Besides revealing the FARC's deal with the Mexicans, Reyes' laptops contained another document that led authorities in 2008 to about 30 kilos of depleted uranium stashed in Bogota. Police said it was connected to the FARC's bid to branch into international terrorism with so-called dirty bombs, which use conventional explosives to spread radioactive material. Such ambitions offer even more reason for concern that the FARC's business skills are evolving to match its tenacity and firepower. |BW|

Big Shots Go Down at Gun Show

FBI arrests in a bribery scandal may leave the firearm industry wounded

By Paul M. Barrett

The setting was Las Vegas, but no one was expecting fireworks at this year's Shot Show, the annual gun industry trade convention. Sure, sales of firearms and ammunition rose in the wake of Barack Obama's victory, as Second Amendment buffs—fearing a Democratic Administration would push new restrictions on weapon ownership—rushed to stock up. Yet what the industry calls the "Obama stimulus" had already started to tail off by the time gun marketers converged on Las Vegas.

Then the feds crashed the party. The FBI used the convention to round up 21 industry executives who allegedly fell for an undercover sting in which they agreed to pay illegal kickbacks to the defense minister of an African nation. In exchange, the small arms marketers thought they were securing the opportunity to sell millions of dollars in weapons and body armor. Unfortunately for them, they were transacting business with FBI operatives posing as middlemen, according to indictments unsealed by a federal judge in Washington. A 22nd suspect was picked up in Miami. "This is one case where what happens in Vegas didn't stay in Vegas," said Assistant Attorney General Lanny Breuer at a news conference.

One of the men arrested in Las Vegas was Amaro Goncalves, a vice-president of sales for Smith & Wesson, the largest U.S. manufacturer of handguns. A federal grand jury alleged that Goncalves agreed to pay a 20% kickback to clinch the sale of 1,825 pistols for use by the presidential guard of the African government (the name of the nation is not revealed in the court filings). Goncalves and the others stand accused of violating the Foreign Corrupt Practices Act, which prohibits bribery in seeking overseas business.

Goncalves' employer has not been charged, and neither has any other company. Smith & Wesson said in a written statement that it has "no information beyond what has been reported" and is "prepared to cooperate fully with law enforcement."

The arrests created a stir among attendees at the Shot Show. The FBI gave the organizers no warning and caught everyone by surprise, says Mark Thomas, spokesman for the National Shooting Sports Foundation, the show's sponsor. But Thomas denies the raid cast a pall over this year's proceedings. "It's business as usual," he says.

7.6%

Drop in mandatory background checks for retail gun sales in December 2009 from year before

Source: National Shooting Sports Foundation.

The gun industry still faces the fizzling of the Obama sales rally. While Smith & Wesson and competitors such as Sturm Ruger and Glock reported strong financial results in 2009, many executives expect a cooling off in 2010, especially in sales of semiautomatic rifles, which had surged last year.

Reliable statistics are hard to come by in an industry where many players are private companies, but one set of data confirms that a shift is already under way. The federal government reported that mandatory criminal background checks, which gun retailers must carry out in advance of a sale, dropped 7.6% in December, to 1.41 million, from the previous year. "Things are getting back to normal, meaning they are slowing down," says Cameron Hopkins, a gun marketing consultant based in suburban Las Vegas who attended the Shot Show. "The good times never last forever." |BW|

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Why Apple May Dump Google

Dropping the search engine as the default on the iPhone would cut Google off from valuable data

By Peter Burrows

The rift between Apple and Google looks like it could get a whole lot wider. Apple is considering replacing Google as the default search engine on its iPhone with Microsoft's Bing, according to two people familiar with the matter. Discussions between Apple and Microsoft have been going on for weeks, say the sources, who caution that a deal with Microsoft is not imminent and may never be reached.

Why would Apple consider replacing the world's most popular search engine with Microsoft's Bing? Apple will probably get more money from Microsoft. But the real advantage of a Bing tie-up for Apple is that it would cut Google off from some of the search data that's the lifeblood of its business. Google has grabbed 65% of the traditional PC-based search market in large part because it has had far more information about what people are looking for and could use that to refine its search algorithms. If it can't get the same kind of data as people shift their computing to the iPhone and other mobile devices, Google risks losing its edge in search. "This would be a significant blow," says Jonathan Yarmis, analyst at the research firm Ovum. "Google would be cut off from the most important platform on the mobile Web."

The discussions over search are part of a broader battle between Apple and Google. The once-close allies have been clashing on an increasing number of fronts. In January, Google unveiled the Nexus One, a smartphone powered by the company's Android operating system that competes with the iPhone. The same day, Apple acquired Quattro Wireless, which three sources have said is part of a broader effort to compete with Google in advertising.



Of course, Microsoft and Apple have a long history of their own clashes. Yet Microsoft is considered less of a threat in the emerging world of mobile computing, and its search technology is viewed as a strong alternative to Google's. Microsoft may also give Apple favorable terms simply so Microsoft can grab a big chunk of the mobile search market and gain ground on Google. "If you have to do deal with the devil," says Forrester Research analyst James McQuivey, "you might as well deal with the one that needs you the most."

The disputes between Apple and Google over data escalated last year, say four sources close to the companies. Apple had agreed to make Google's search the default on the iPhone years ago, when the two companies were on good terms, and as part of that deal Google got access not only to search queries but also GPS data that helped pinpoint where iPhone users were at any given time. That allowed Google to create a virtual map of the U.S. and a real-time view of where people are using their phones. Last year, Apple told Google it wanted to stop sharing location data, say the four sources. Apple spokeswoman Katie Cotton and Google spokeswoman Katie Watson declined to comment.

MORE TARGETED ADS

Such location data is sure to be crucial in the future, experts say. Knowing how many smartphone users are driving on a particular highway is the best way to predict traffic conditions, says George Fink, the former president of digital map-provider Tele Atlas. Location data could also be used to make mobile advertising more targeted and useful. General ads for, say, a Cadillac or mortgage broker may not be very effective if they show up on a mobile phone, but ads for a sale at a store around the corner or for cheap beer at a nearby bar may prove more appealing. Danny Sullivan, founder of the blog Search Engine Land, says such an advertising approach is a "no-brainer."

Microsoft does have valuable attributes other than not being Google. It's got excellent mapping technology and is a leader in voice technologies, which are becoming increasingly popular as a hands-free way to control smart devices. Still, Apple may only be looking for a short-term relationship. One source close to the company says it is considering developing its own search technology. "If Apple does do a search deal with Microsoft, it's about buying itself time," the person says.

Whatever the long-term strategy, Apple is taking a big risk. Google's name is practically synonymous with search. After Microsoft signed a deal to pay millions to unseat Google as the default on certain BlackBerry devices on Verizon Wireless's network, the carrier got so many complaints it issued a press release in December showing consumers how to switch back to Google. "While there may be good reasons for Apple consorting with Microsoft, this is consorting with an inferior competitor," says Larry Fox, founder of a long-running Apple user group. "Bing is inferior to Google." | BW |

JOE RHAMES/BW

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Monsanto Sets A Soybean Free

The seed giant won't stop a bioengineered variety from going off patent but will still fiercely guard new products

By Jack Kaskey

Beset by federal antitrust lawyers, a deep-pockets competitor, and a barnful of groups opposed to genetically modified crops, Monsanto is suddenly playing Mr. Nice. Chief Executive Hugh Grant says the company will let patents on its bioengineered farm seeds expire without a fight, starting with its ubiquitous Roundup Ready soybeans in 2014. The move would allow rivals to make cheaper knockoffs—and farmers to plant these seeds from their own harvests—without legal restriction for the first time since 1996.

Don't expect Monsanto to turn into Mr. Pushover, however. The world's biggest seed company has begun selling new versions of herbicide-resistant soybeans and corn, with other gene-modified products to follow in 2011. Monsanto will be just as tough in protecting these patents, a strategy that has helped it capture 93% of the U.S. soybean crop with its first-generation biotech seed. To achieve that dominance, the company has also relied heavily on licensing rights to other producers. Says Scott S. Partridge, Monsanto chief deputy general counsel: "We are going to seek appropriate protection under existing patent laws."

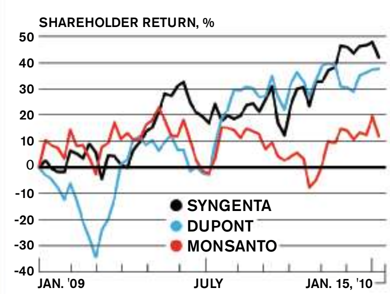
Monsanto's conciliatory gesture hasn't helped so far. The St. Louis-based company disclosed in mid-January that it has turned over millions of pages of documents to the U.S. Justice Dept. as part of a civil investigation into allegations of anticompetitive behavior in its soybean business. In addition, DuPont, the seed industry's No. 2 company, is suing Monsanto, accusing it of exploiting its market position and technology licenses to block products from DuPont's Pioneer-Hi Bred International unit and other companies.

Monsanto's stock, which soared from 10 a share in 2000 to almost 140 in mid-2008, is down more than 40% from its peak and has barely budged over the past year; it closed at 81.42 on Jan. 20, lagging both DuPont and Syngenta, another competitor, in price appreciation. In its fiscal first quarter, which ended Nov. 30, Monsanto lost $19 million as revenue tumbled 36%, to $1.7 billion. The company blamed the loss on plunging sales of Roundup weed killer, as farmers turned to generic varieties.

Grant, 51, sees a bounceback by 2012. Although activists continue to decry bioengineered crops—Monsanto was tarred in a recent documentary, *Food Inc.*—Grant notes that over the past 18 months Brazil, Mexico, Argentina, India, and China have opened the door to genetically modified crops or research. He sees that as a sign that fears of food shortages are trumping what he says is unfounded anxiety about safety.

INDUSTRY LAGGARD

Monsanto's stock has underperformed rivals' over the past year



Data: Bloomberg



Monsanto is counting on Roundup Ready 2 soybeans to keep its coffers full

PHOTOGRAPH BY BRYON HOULGRAVE/THE GLOBE GAZETTE/AP PHOTO; CHART BY STANFORD KAY/BW

New products may win over more converts. Monsanto is already marketing Roundup Ready 2 soybeans, which produce greater yields. This spring in the U.S. it is introducing a new corn with genes that make it immune to herbicides and a host of insects. A drought-resistant variety will follow in 2012. Monsanto scientists are also manipulating wheat DNA to produce a drought-hardy strain, which would open a new market for the $11.7 billion company.

Grant is betting that sales of these higher-priced, second-generation seeds will more than offset the loss of sales of earlier versions as their patents expire. "Growers will decide, 'Do I go with the old 1996 material or do I go with some of these new varieties?' " Grant says. "I'm fine with that setup." |BW|

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The Long Road Back From Massachusetts

After the upset, the best the Dems can hope for may be a watered-down health bill with insurance reforms

COMMENTARY

By Albert R. Hunt

When Harris Wofford scored an upset win in a 1991 special election—the first Democrat to win a U.S. Senate seat in Pennsylvania in almost 30 years—the political earth moved, presaging the party's triumph in the national elections the following year and putting health-care reform on the agenda. It was a major tremor, a 6 on the political Richter scale. The stunning victory of Scott Brown in this week's special election for Ted Kennedy's seat, the first Republican to win a Senate seat in Massachusetts in 37 years, was an earthquake, an 8 on that same scale.

Only a year after the euphoria of Barack Obama's inaugural, the President and his party have been sapped of vitality. With reactions ranging from despondency to panic, efforts to paint the Massachusetts results as sui generis are a nonstarter.

"Special elections have special ramifications," says Democratic pollster Peter Hart. "The House voted to impeach Nixon [in 1974] after special elections sent a message. Pennsylvania sent a message [in 1991] that things are going to change." The Massachusetts message to Democrats, he says, is simple: "You're not getting the job done." Vin Weber, a former Republican congressman and a prominent political strategist, agrees. "This is not about Republicans," he says. It's about an overreaching Democratic agenda which has people frightened. They believe the expansion of borrowing, spending, and taxing is the principal threat to recovery."

The implications are far-reaching. Prospects that Obama will succeed on his signature issue, a health-care overhaul, have gone from 80% a week ago to less than 50-50 today; all of the Democrats' options to revive the measure over the next few weeks are full of lethal land mines. Their only chance may be, as Obama conceded after the Massachusetts shock, a vastly scaled-back bill, including insurance reforms but no guarantee of coverage for 30 million Americans, and expanded Medicaid



for poorer people with higher taxes. If the President got this, by no means a given, it would be a huge retreat from his promises.

SELF-PRESERVATION MODE

The President's clout on other big issues, from financial regulation and the bank tax to deficit reduction, has eroded. He tried to save the Democratic candidate on the eve of the Massachusetts election and proved only that he wears what's called an Eisenhower jacket: no coattails.

It also was a devastating setback for White House Chief of Staff Rahm Emanuel. His influence and effectiveness only a short while ago were compared to James Baker, who held that job under Ronald Reagan. If the health-care measure fails, those comparisons will stop. On Capitol Hill, nervous Democrats are in a self-preservation mode, party be damned. Many believe what they do this year in Washington won't help much in November. "The traction for Democrats is not going to come from legislation," says pollster Hart.

Republicans believe the special election augurs well for them in November. "We have candidates who were on the fence now talking about taking the risks," says California Congressman Kevin McCarthy, the GOP's head political strategist in the House. "They figure if we can win in Massachusetts, we can win anywhere." Moreover, he thinks about a half dozen more Democrats are now likely to retire, bringing the total to 17 and giving Republicans a real shot at winning the 40 seats necessary for control of the House.

In the Senate, Majority Leader Harry Reid's shaky reelection prospects look even worse. The failure of the Nevada Democrat and others, including the White House, to pressure party liberals for more expeditious action on health care last fall will prove a catastrophic miscalculation if the bill dies.

Obama has the venue for a fresh start and strategy with his State of the Union address. What will it be? "They haven't the foggiest idea; they're shell-shocked," says one leading Dem who regularly talks to Obama's chief advisers.

The most predictable and ominous indicator is the finger-pointing that started even before Bay State voters went to the polls. Anonymous top White House aides were blaming the likely debacle on a flawed candidate, her pollster, and the Senate Democratic campaign committee.

Democrats outside the White House, also insisting on anonymity, noted Tuesday's election was for the seat held for 47 years by Ted Kennedy, the pol most identified with health-care reform. The centerpiece of candidate Brown's insurgency was a vow to provide the decisive vote in the Senate against the Obama health-care plan. That resonated in Kennedy's Massachusetts, a testament, they say, to the White House's inability to articulate a message. |BW|

RAY BARTKUS

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SPECIAL REPORT

Washington & Business

OBAMA STARTS OVER

After a tough first year, the President's economic agenda and standing will be challenged again in 2010 by soaring joblessness, ugly budget deficits, and Obama fatigue among independent voters

By Rich Miller and Mike Dorning



PETE SOUZA

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The President may be forced to pare back his change agenda in year two

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As President Barack Obama was preparing for a major policy speech on the economy in December, he erupted at his economic team. Budget Director Peter Orszag argued in a White House meeting that more emphasis should be put on reducing the deficit, while chief economist Christina Romer led a contingent advocating for a greater short-term focus on jobs. They were familiar refrains, and Obama was frustrated. "Why are we having this meeting again, the same discussion?" participants quoted him as saying. ¶ Welcome to year two, Mr. President. It won't require the same high-wire act as year one, when Depression 2.0 was staved off with a jumbo stimulus package, massive cash injections into the battered banking system, and bailouts of the auto industry. Instead, as he prepares to deliver his State of the Union address on Jan. 27 and his budget on Feb. 1, Obama has to clean up the damage done by the now-ended Great Recession: the budget deficits on the government's books and the sliding job market his aides were arguing over. Only after that will he be able to turn his full attention to his long-term "change" agenda.

For Obama, 2010 will be a year of finding 10% solutions. Last year's $1.4 trillion budget deficit is nearly 10% of the economy, and the unemployment rate is also stuck at 10%. And here's the dilemma: Cut the budget deficit by raising taxes or reducing spending and you risk slowing down the economy and pushing up unemployment. Spur job creation through tax credits for new hires or infrastructure spending and you blow out the budget.

"He's got a needle to thread," says John Podesta, an Obama confidant and head of the Center for American Progress, a Washington think tank. "He wants to try to get as much as he can done in 2010 on the economy while paying attention to the long-term debt problems of the country."

That job got a whole lot harder with Republican Scott Brown's surprise victory in the recent Massachusetts special election, robbing Obama's Democrats of their super-majority in the Senate and threatening the President's health-care overhaul push. The setback left Democrats questioning Obama's decision to focus most of the party's energy on health care, rather than focusing more on jobs and the economy. Now, with independent voters souring on Obama, vulnerable lawmakers are likely to be reluctant about casting votes on other controversial issues such as caps on carbon emissions, tax reform, and a revamp of entitlement programs ahead of November's midterm elections. The White House may have to pare this year's legislative wish list.

Obama, who frequently invoked Martin Luther King Jr.'s "fierce urgency of now" mantra during the Presidential campaign, doesn't have time to waste. The longer unemployment remains high, the more likely it is that discouraged job-seekers will drop out of the labor force.

Government borrowing and debt, meanwhile, have reached "very worrisome" levels, says former Federal Reserve Chairman Alan Greenspan, risking a rise in long-term interest rates.

The President and his economic team have been brainstorming for months over how to solve the budget and job deficits and still move ahead with his broader economic agenda. One proposal: tapping the $700 billion bank bailout fund to help small business owners get credit. Another would lower the principal amount on underwater home loans, in which a house's value is less than the balance due.

"ERODING CUSHION"

Obama also wants to boost exports by easing restrictions on high-tech products that can be shipped abroad. He's considering more investment in broadband technology to expand its use for distance learning and rural health care. And he wants to provide tax credits to encourage retrofitting of homes to boost energy efficiency. "The most important part of our strategy for this year is to get the economy growing to create jobs through a combination of direct action, promotion of private investment, and promotion of exports," says Lawrence Summers, Obama's National Economic Council head.

No less than the fate of Obamanomics—the grand vision that the President laid out during the 2008 campaign—is at



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Diana Farrell

NEC aide to Larry Summers

One of three deputy directors under Larry Summers, head of the National Economic Council, Diana Farrell has been the White House's point person on the auto industry rescue, financial regulatory reform, and the housing crisis. She's also the economic team's lead staffer on climate change and competition policy. Farrell, 44, wrote the policy paper that laid the groundwork for the Obama Administration's "hands off" approach toward running companies it partly owns as a result of bailouts. Before she joined the Administration she led the McKinsey Global Institute, the economic research arm of the consulting firm. She once provoked the ire of protectionists, including former CNN commentator Lou Dobbs, with a 2003 paper arguing that every dollar spent "outsourcing" jobs created a net benefit to the U.S. economy of $1.13. Farrell grew up in Bogota; her father worked overseas for General Electric and her mother is Colombian. Farrell, who moved to the U.S. to attend Wesleyan University and earn a Harvard MBA, is married and has two children.

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Without job growth, the economy will continue to suffer

enough for the party to maintain only a diminished hold on Congress. "There is still a little bit of a cushion for Democrats," Cook says. "But the cushion is eroding on a weekly basis."

Almost everything that happens in Washington this year will be influenced by the midterm races. Obama aides, for example, have discussed tackling Social Security reform, but are unlikely to do so in 2010. Orszag proposed a plan to fix the retirement program when he was in the private sector, and some outside advisers are eager for the President to take on the issue. Those inside the Administration, however, say any reforms would likely be phased in over the coming decade, with little immediate effect on the deficit. Any budgetary benefit, then, would not outweigh the political risk of alienating Obama's liberal base in an election year.

stake. Even if Obama manages to clinch his first big win—a national health-care plan that Democratic administrations since Harry Truman have failed to achieve—his ambitions don't stop there. He wants to set "a new foundation" for the nation's economy: a better-educated workforce, more energy-efficient businesses, and an auto industry less reliant on polluting fossil fuels. Obama wants economic growth that's driven by investment and exports rather than consumption and debt. And he wants economic rewards to be more widely shared and expansions to last longer.

Last year, Obama cloaked some of his aspirations in the guise of fiscal stimulus, seeding the $787 billion package with small down payments to get desired programs started. His cap-and-trade plan to limit carbon emissions has languished, but the stimulus package funded alternative energy projects and work on a "smart grid" to ease transmission of power from new sources. While major education reforms have waited, the stimulus legislation included $4.35 billion in state grants to promote teacher accountability and turn around struggling schools. As the health-care overhaul process droned on all year, a pilot program to digitize medical records was in the works, compliments of the stimulus measure.

Building a new economic foundation will be impossible if Obama fails to convince voters before congressional elections in November that the Democratic Party has what it takes to solve the budget deficit and employment gaps.

Charlie Cook, editor of the nonpartisan Cook Political Report, now projects that Democrats will lose 4 to 6 seats in the Senate and 20-30 seats in the House in November,

JUSTIN LANE/EPA/CORBIS

AN ANTI-WALL STREET MESSAGE

Ominously for Wall Street, the President's call for $117 billion in new taxes on large banks and his war of words with the industry—last week he called their bonuses "obscene" and belittled their lobbying campaign to stop the tax as "a sight to see"—signals a new phase of economic populism among Democrats looking for a winning theme in November. The anti-Wall Street message could become a factor as Congress works on an overhaul of financial regulation. Even Democratic leaders in the House, which approved a measure in December, are considering new executive pay restrictions.

The bank levy is one way the President hopes to signal his seriousness about the budget deficit. He is also likely to sign on to a bipartisan commission that would suggest tax increases and spending cuts to slash the deficit. Under a tentative agreement worked out with Congress, the President would issue an Executive Order to create a panel and lawmakers would vote on its recommendations.

There's little doubt that the White House, with no small help from Ben Bernanke and his colleagues at the Federal Reserve, has succeeded in engineering a recovery of the economy. Economists surveyed by Bloomberg in January put the chances of a double-dip recession at just 15%.

Yet the Obama team isn't ready to declare victory. While the economy may have bottomed out, it's a long way from making up the ground lost during the 1½ year downturn. "When you are in the Grand Canyon you can be climbing uphill, but you are still in a canyon," Summers says.

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The fear is that, as the structural forces of globalization and automation discourage employers from hiring, the hallmark of this recovery, like the last two in 1991 and 2001, will be stubbornly high unemployment. If that's the case, then the Administration's targeted employment schemes may not make all that much difference. "We could have the mother of all jobless recoveries," says Allen Sinai, chief global economist at New York-based consulting firm Decision Economics. Obama's economic team is betting that job growth will recover by spring. Government hiring will also give the job market a lift, albeit temporarily, as the U.S. Census Bureau gears up for its once-a-decade survey of the American public.

Following House passage of a jobs bill last year, Administration officials are working with Senate Democrats on their own measure, including expanding the Export-Import Bank's ability to support more companies looking to sell their goods abroad. The bank provided a record $21 billion in financing for overseas sales by U.S. companies in the last fiscal year and is slated to top that this year, says Fred P. Hochberg, president of the bank.

Officials are also looking at what they can do without congressional action. Under one plan that's been discussed, the Treasury would make part of the existing bailout fund available to community banks so they could tap it to provide credit to small businesses without being subject to pay and other restrictions laid down by Congress.

Obama and community bankers: He'd like them to get bailout funds

SPENDING STILL TOO TIMID?

Struggling homeowners may also be in line for extra help. Housing experts say the Administration is discussing a novel idea to encourage banks to write down the principal on mortgages, a step lenders have been loath to take because it requires them to declare a loss on the loan.

Some prominent liberal economists, including Nobel-prize winners Paul Krugman of Princeton University and Joseph Stiglitz of Columbia University, say the Administration is being too timid. They argue that the hole in the jobs market is so big, another massive jolt of stimulus is needed.

Others warn there are limits to how far the government can go. A paper presented this month by Carmen M. Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University concluded that economies throughout history have tended to slow sharply after government debt levels hit 90% of gross domestic product. The U.S. is

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around 85%. "We're in a very treacherous area," Greenspan says. "We're now eating into the buffer between the federal debt held by the public and our capacity to borrow. That has never happened before."

The Administration is aiming to stabilize the debt ratio by reducing the government's annual budget deficit by 2015 to about 3% of the overall economy, in line with annual growth of gross domestic product. To get there, the President will have to take significant steps, including cutting politically popular programs.

Obama, though, is constrained by his past promises and actions. He took a huge swath of potential revenue off the table by promising not to raise taxes on families making less than $250,000 a year. Meanwhile, his decision to put more troops on the ground in Afghanistan means he can't count on reduced military outlays as the U.S. withdraws its forces from Iraq. After a bruising fight over health-care reform, Congress will have little appetite to revisit the topic to wring more savings out of Medicare and Medicaid.

INTEREST-RATE FRICTION

The President also can't count on the same help that Bill Clinton received from the Fed and the bond market when he cut the deficit in the 1990s, says Princeton University professor and former Clinton economist Alan S. Blinder. The tightening of the fiscal screws back then allowed the central bank eventually to ease monetary policy and paved the way for a dramatic 2.5 percentage point reduction in long-term interest rates that boosted growth and jobs. That can't happen this time with the short-term interest rates that the Fed controls already close to zero—as easy as it gets.

Blinder, a former vice-chairman of the Fed, is betting that the central bank will raise rates at midyear. If so, that could cause friction between the Fed and Democratic lawmakers who want interest rates to remain as low as possible—at least until they get reelected in November—to make it easier for businesses to obtain credit and create jobs.

Obama has hinted that he wants changes in the entitlement programs and tax policies that drive the deficit. During the campaign, he did what Democratic primary rival Hillary Clinton would not, gingerly touching the third rail of American politics with a proposal to bolster the Social Security system's long-range finances by lifting the cap on earnings subject to the payroll tax.

The struggle over health care has dragged into the congressional election year, squeezing out the chance of doing something on Social Security. The focus is now on the deficit-reduction commission, which at best would prepare the ground for action after the midterm elections. Public pension reform looks promising to policy analysts because it requires relatively simple tweaks to taxes, benefit levels, and retirement ages. But the politics look harder in a capital consumed by bitter partisanship and with the electorate uneasy about its own finances.

"If you want to do these megaprojects, it's best to do them at a time when the economy is humming along, because people feel good about the economy and they are willing to take a risk. When the economy is not doing well and they're worried about their job or out of a job, then they're a lot less risk-prone," says House Budget Committee Chairman John M. Spratt Jr.

But Obama won election by inspiring a wave of enthusiasm that brought large numbers of new voters to the polls. Even if it means taking political risks, his best chance of renewing the coalition that brought him to office is to continue to aim high, says Democratic strategist Tad Devine. "I think you can mobilize that electorate with an agenda that's forward-looking. In all these issues—deficit, entitlements, climate change—they are very future-oriented."

As Obama begins his second year in office, he again faces challenges the U.S. has not seen for generations. If he can spur the job market without increasing government spending, he may be able to defuse voter anger and limit Democratic losses in November. If not, his shot at delivering on the big changes he insists are necessary for America to make the 21st century its own may slip away for the rest of his term. |BW|



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Lee Sachs

Counselor to Geithner

From Timothy Geithner's first day at the Treasury, longtime colleague and tennis partner Lee Sachs has been at his side. Sachs, 46, bird-dogged the Administration's effort to devise a financial stability plan and reshape the $700 billion bank bailout it inherited. He's now figuring out what to do with Fannie Mae and Freddie Mac, the troubled housing-finance giants. It's his second Treasury tour: In the Clinton Administration, he rose to the Senate-confirmed post of Assistant Secretary for financial markets. He and Geithner, then in the international affairs shop at Treasury, bonded over late-night pizza while grappling with the Asian financial crisis. This time around—with some Democratic lawmakers making clear they wouldn't vote for officials with strong ties to Wall Street—Sachs was not tapped for a job that required a Senate vote. He worked at now-defunct investment bank Bear Stearns from 1985-98, rising to senior managing director at 27 and later joining the board. Besides tennis, Sachs relaxes by fly-fishing, but he doesn't tie his own flies.

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Fed insider Parkinson once backed light regulation of derivatives

An Unlikely Guardian

Bank monitor Patrick Parkinson's intellectual backflip on policing derivatives has skeptics worried

By Robert Schmidt and Scott Lanman

When the definitive chronicle of America's Great Recession is written, Patrick M. Parkinson will merit more than a footnote. Rewind to the late 1990s. Federal Reserve Chairman Alan Greenspan wanted derivatives kept free of government oversight. He relied on Parkinson, then a midlevel manager in the Fed's division of research and statistics who was especially knowledgeable about how derivatives worked, to help make his case. As Parkinson told Congress in 1999, it was "unnecessary" for the government to supervise over-the-counter derivatives because the companies that trade them "are quite adept at managing credit risks and are more likely to base their investment decisions on independent judgment."

They won the fight when a Republican-controlled Congress passed the Commodity Futures Modernization Act of 2000. "[Parkinson] understood all of the complex derivatives, their pros, their cons, and their difficulties," Greenspan told *Bloomberg BusinessWeek*. Seven years later, derivatives played a central role in igniting the worst recession in half a century. After a year of emergency interventions, temporary backstops, and stimulus spending, Congress and the Obama Administration are at work on legislation to permanently fix the financial system.

And Parkinson? He's had a change of heart—and been promoted. Fed Chairman Ben Bernanke in October put Parkinson in charge of monitoring the nation's biggest banks as the director of the Banking Supervision & Regulation Div. Parkinson also spent part of last year helping the White House produce a new road map for financial regulation that forces many derivatives to trade on open exchanges or regulated electronic systems. That plan would give the Fed the role of super-regulator of the most important financial companies—a position Parkinson will hold if Congress approves.

His critics are dumbfounded. "We're not only putting the fox in charge of the henhouse," says Lynn Turner, the chief accountant at the Securities & Exchange Commission from 1998-2001, "we're giving him a bottle of barbecue sauce."

To others, Parkinson could be the ideal bank supervisor. President Franklin D. Roosevelt, they point out, installed Joseph P. Kennedy Sr., who made millions in the 1920s by taking advantage of uninformed investors, unregulated markets, and the absence of insider trading rules, as the first head of the SEC.

Brooksley Born, the former chief of the Commodity Futures Trading Commission, is giving Parkinson the benefit

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of the doubt. She crossed swords with him when she opposed the 2000 act, which kept the instruments trading in unregulated, opaque markets and triggered the explosive growth of contraptions like collateralized debt obligations.

Born sought to use existing commodities laws to regulate derivatives after seeing the role they played in the collapse of Long-Term Capital Management, a Greenwich (Conn.) hedge fund. At the time, Parkinson stunned her when he first contended that the CFTC had no authority to supervise over-the-counter derivatives. While Born lost that battle, she now praises his work on the Obama financial reform plan, calling the proposal on derivatives "an enormous step forward."

MISGUIDED FAITH

Parkinson, who has a PhD in economics from the University of Wisconsin, admits his faith in self-policing markets was misguided. "Obviously, the shortfalls in market discipline weren't something that developed just in the last three years," he says. "We had overestimated all along."

John Dearie, executive vice-president of the Financial Services Forum, a Washington trade group for the CEOs of large financial firms, says it's understandable "and even admirable" that a civil servant like Parkinson would rethink his views. "As John Maynard Keynes famously said, 'When my information changes, so does my conclusion,'" says Dearie.

In an interview with *Bloomberg BusinessWeek*, Parkinson described his foxhole conversion. As a staff adviser to Bernanke in 2008, he closely witnessed both the Fed's rescue of Bear Stearns and American International Group and Lehman Brothers' collapse into bankruptcy. Money-market mutual funds with investments in Lehman-issued debt, for example, lost value overnight; the venerable Reserve Primary Fund actually "broke the buck," in which the value of a share fell below the long-time standard of $1.

Parkinson quickly fashioned a Fed guarantee to backstop the money-market funds, in which millions of Americans had invested their savings even though they weren't guaranteed like bank deposits. The guarantee worked, and the funds were saved.

Assistant Treasury Secretary Michael S. Barr, who worked with Parkinson and other officials to craft the Obama regulatory plan, says that Parkinson provided "invaluable" advice, especially on derivatives. One of the unabashed liberals at the Treasury, Barr says Parkinson is "a skeptic" rather than an ideologue.

Running the bank examination division at the Fed hasn't been a plum assignment. Parkinson's new offices on K Street are a downgrade from his digs in the Fed's Constitution Avenue headquarters overlooking the Lincoln Memorial. His unit, which has about 3,000 staffers still weary from criticism that they failed to oversee Citigroup, Bank of America, and other bailed-out firms, is being revamped so it has a better window on such activities as consumer lending, commercial paper, securitized loans, and mortgages. The Fed's new examination process builds on the stress tests of the biggest banks conducted to much acclaim last year. Examiners will also be looking at new risk factors and plan to do their reviews with an eye on the broader banking system rather than just individual banks.

At first, Parkinson resisted officials' pleas to run the group. The Milwaukee native, whose father, grandfather, and great-grandfather were all locomotive engineers, was nearing 30 years at the Fed. He wanted to retire and pursue his passions, including bird-watching. Parkinson now seems happy to have let the binoculars wait. At the division's holiday party, staffers sang a rendition of *The Twelve Days of Christmas*, with a final twist: They changed the last line of "A partridge in a pear tree" to "A director with a PhD." Parkinson, who could pass for a svelte Santa Claus, sang along. |BW|



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Michelle Smith

Federal Reserve spokeswoman

Michelle Smith had resigned from the Federal Reserve in 2006 and was preparing to join the just-retired Alan Greenspan at his consulting firm when she changed her mind. Instead, she chose to stay on with Ben Bernanke as a strategic adviser and spokeswoman. Lucky Bernanke. Throughout the financial crisis, the Fed chairman has trusted the 41-year-old to help make the central bank more transparent and to explain its extraordinary actions to a skeptical public. It was Smith's recommendation that Bernanke court audiences beyond Congress and Wall Street; traditionally the Fed chief sticks to scripted remarks lest a slip of the tongue send markets spinning. The glasnost strategy worked: He cooperated with CBS's *60 Minutes* for what turned out to be a sympathetic profile, and *Time* named him "Person of the Year." Smith, a Dallas native, began as a mail clerk for then-Texas Democratic Senator Lloyd Bentsen in 1992. She moved to the Treasury Dept. when Bentsen became Secretary and worked for his successors, Robert E. Rubin and Lawrence H. Summers. Now President Obama's chief economic adviser, Summers unsuccessfully tried to bring Smith with him when he became president of Harvard University in 2001.

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Market-Mover-in-Chief

U.S. stock performance in the year following the inauguration of a new President

By Tara Kalwarski / Chart by Stanford Kay



PRESIDENT/INAUGURATION DATE	PERCENTAGE CHANGE IN THE DOW JONES INDUSTRIAL AVERAGE (FOUNDED IN 1896) DURING FIRST YEAR IN OFFICE	
FRANKLIN DELANO ROOSEVELT Mar. 4, 1933	96.5%	The Dow Jones industrial average rose by an average 9% a year during FDR's 12-year tenure.
HARRY S TRUMAN Apr. 12, 1945	30.9%	Almost 18 years after reaching 200 for the first time, the Dow again climbed to 200 in January 1946.
BARACK OBAMA Jan. 20, 2009	29.5%	At 468%, Genworth Financial was the best-performing S&P 500 stock during Obama's first year in office.
LYNDON B. JOHNSON Nov. 22, 1963	21.6%	The Dow increased 27% over the length of Johnson's five-plus years in office, or about 5% a year.
GEORGE BUSH Jan. 20, 1989	19.6%	The 1980s ended during Bush's first year, with the Dow rising 228% over the decade, or 13% a year.
WILLIAM J. CLINTON Jan. 20, 1993	19.3%	The industrial sector was the best-performing sector in the 12 months following Clinton's inauguration.
CALVIN COOLIDGE Aug. 3, 1923	15.8%	DuPont made its first appearance in the Dow in January 1924, almost six months after Coolidge took office.
WARREN G. HARDING Mar. 4, 1921	14.9%	The bear market that began in 1919 ended on Aug. 24, 1921, with the Dow having lost almost 47%.
WILLIAM HOWARD TAFT Mar. 4, 1909	12.1%	Taft established the National Monetary Commission to propose a banking reform plan during his first year.
JOHN F. KENNEDY Jan. 20, 1961	10.8%	The U.S. economy grew 6% in 1961, more than any other President's first year since at least 1948.
GERALD R. FORD Aug. 9, 1974	4.2%	The Dow fell 45% between Jan. 11, 1973, and Dec. 6, 1974, one of the worst bear markets in history.
WOODROW WILSON Mar. 4, 1913	0.5%	After World War I began during Wilson's second year, the U.S. stock market closed for 4 1/2 months.
DWIGHT D. EISENHOWER Jan. 20, 1953	0.5%	The Dow hit a bottom in September 1953 and then went on to double over the next 2 1/2 years.
THEODORE ROOSEVELT Sept. 14, 1901	-1.8%	The Dow dropped by 23% during Teddy Roosevelt's second year on the job.
GEORGE W. BUSH Jan. 20, 2001	-7.7%	During his eight years in office, the Dow fell 22%, to 8,281. The S&P 500 lost 37%, closing at 850.
RONALD REAGAN Jan. 20, 1981	-12.7%	The prime rate topped 21%—the highest level on record—during Reagan's inaugural year.
HERBERT HOOVER Mar. 4, 1929	-15.6%	The Dow dropped 48% from Sept. 3 to Nov. 13 in 1929.
RICHARD M. NIXON Jan. 20, 1969	-17.0%	The Dow also lost 17% during the first year of Nixon's second term.
JIMMY CARTER Jan. 20, 1977	-19.6%	Inflation increased by more than 6% during Carter's first year.

Average change in the Dow during a President's first year

Democrat	24%
Republican	1%

Data: Bloomberg

(FDR, HST, CC, WHT, WW, TR, HH) STOCK MONTAGE/GETTY IMAGES; (LBJ) GETTY IMAGES; (WGH) BETTMANN/CORBIS; (JFK) AP PHOTO; (RMN) WHITE HOUSE PHOTOS/GETTY IMAGES

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[4]Before 2010, conversions of traditional retirement accounts to Roth IRAs are restricted to households with adjusted gross income (AGI) under $100,000.
[5]Before and after 2010, taxes owed on pre-tax contributions and investment gains in tax-deferred accounts converted to a Roth IRA must be paid in the year the conversion takes place. For 2010 only, taxes owed on pre-tax contributions and investment gains in tax-deferred accounts converted to a Roth IRA may be spread over two years (2011 and 2012). However, if your modified AGI is above a certain amount, your contribution limit may be reduced. Consult your tax advisor on these rules.

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Dancing Across The Aisle

The Senate odd couple who just might pull off a bipartisan deal on financial regulation

By Alison Fitzgerald

Among the thousands of people shivering through President Barack Obama's inauguration a year ago, Senators Mark Warner (D-Va.) and Robert Corker (R-Tenn.) happened to sit next to each other, and their bone-chilling time together yielded something rare in Washington: genuine bipartisan warmth. "He and I just kind of hit it off," says Warner. It turns out the two ex-businessmen had a bond. "We could both read a balance sheet," Warner recalls.

There's plenty that separates the first-term senators. They clash on everything from health reform to abortion to organized labor. But the friendship forged on Inauguration Day could pay dividends on financial regulation. Warner and Corker, both members of the Senate Banking Committee, are working across party lines on a compromise on one crucial aspect of the effort to strengthen the federal government's ability to stave off another Wall Street crisis.

Their collaboration contrasts with congressional acrimony on health care and other topics. "The word from the Republican leadership is for the most part: Don't cooperate on Obama's agenda," says Thomas Mann, a political analyst at the Brookings Institution. The Banking panel "is the only place in the entire Congress where Democrats and Republicans are actually talking together."

Corker and Warner characterize themselves as pragmatists shaped by entrepreneurial success. They are two of the 10 wealthiest members of the Senate, according to the Center for Responsive Politics, a Washington research group. Warner, who headed a

First-term Republican Corker made his fortune in construction

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technology venture capital firm before getting into politics, has an estimated net worth of $210 million. Corker made his mark in construction and has an estimated $52 million. Both have served as government executives as well: Warner as governor of Virginia, Corker as mayor of Chattanooga.

The pair differs as much in appearance and demeanor as in politics. Warner, 55, stands 6-feet 2-inches and speaks with boyish enthusiasm. Corker, 57, is 5-feet 7-inches, favors well-cut suits, and likes to grill witnesses at hearings in a loud Tennessee-tinged voice.

Behind the scenes, they work effectively—for example, by hosting a periodic bipartisan salon where senators and staff confer privately with financial experts. "The lobbyists aren't there. The media isn't there. They can talk more openly," says FDIC Chairman Sheila Bair, who has briefed lawmakers at a Corker-Warner session. "If a member wants me to explain what a CDO is for him, there's no reason to be embarrassed." Members of Congress typically seek counsel from outsiders individually or through their party caucuses.

Now, at the request of retiring Banking Committee Chairman Chris Dodd, Corker and Warner are one of four bipartisan teams of bank panel members drafting parts of the Senate's version of regulatory reform legislation. The House passed its legislation on the topic last year; the two approaches differ on such issues as whether to have a single bank regulator and will have to be reconciled.

A COMPROMISE PLAN

Corker and Warner are focusing on how federal officials should oversee giant financial institutions. Some Democrats and regulators such as Bair think executive branch officials should have greater authority to wind down large financial companies, including those that aren't banks. Republicans prefer that failing firms be forced into conventional bankruptcy proceedings.

Corker and Warner are drafting a compromise that would create a new financially expert bankruptcy court. That body, rather than an executive-branch agency, would have the power to dismantle a faltering financial institution. The court would be led by judges trained to deal with highly complex companies that have seized up and threaten the stability of the financial system, according to people familiar with the proposal. The compromise plan would allow regulators to intervene in the legal proceedings to take control of the failing institution's wind-down—and lower expectations of future government bailouts.

The idea faces opposition from some Democrats and regulators, including Bair's FDIC, which now presides over workouts of failed banks. Even Corker and Warner's own banking staffers were uneasy about cooperating with the other side—at least until the two senators arranged a drinking session at Johnny's Half Shell near the Capitol . If only all bipartisanship came at happy-hour prices. |BW|


Democrat Warner was a successful tech venture capitalist

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STEPHEN VOSS

Can the FOB at the FCC Improve the Web PDQ?

Julius Genachowski is a Friend of Barack—and the man charged with turbocharging broadband

By Tom Lowry

Julius Genachowski is not a member of President Barack Obama's Cabinet, but the chairman of the Federal Communications Commission is likely to have more influence on our lives than many Obama Cabinet secretaries.

Why? In a word, broadband. Obama has asked Genachowski to come up with a road map to make speedy Web access more ubiquitous and robust so the U.S.—an international broadband laggard—can gain a technological edge. The FCC will present its recommendations to Congress in mid-March.

For now, the FCC will provide only a broad outline of the plan. But it says it will recommend ways to bring more

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Genachowski is the rare FCC chief with day-to-day business experience

Americans online, boost competition among broadband providers, and attract private-sector money to everything from new wireless infrastructure to funding technology startups. "Broadband is an essential platform for growth and opportunity," says Genachowski. "It will be to this century what the universal electrical grid was to the 20th century when it comes to jobs and innovation."

Genachowski, 47, is an unusual kind of FCC chairman in that, more than any of his predecessors, the President actually seems to pay attention to him. He and Obama have been friends since they attended Harvard Law School in the early '90s. Genachowski went on to work at the FCC, then helped Barry Diller build his e-commerce empire. When Obama ran for President he asked Genachowski to advise him on technology matters. The two remain close, and Genachowski often joins Obama's pickup basketball games.

'WILLING TO LISTEN'

Genachowski is the rare FCC chief with day-to-day business experience. During eight years at Diller's InterActive Corp., he was chief of business operations and general counsel. Genachowski also shares the Obama team's reputation for pragmatism. This makes him a very different animal from his predecessor, Kevin J. Martin, a former communications lawyer who is best remembered for his crusade to rid the airwaves of what he considered smut.

Executives say that the new FCC chief is accessible, inquisitive, and disarming. "In areas where we may disagree," says Steve Largent, an ex-congressman and chief lobbyist for the wireless industry, "he has been willing to listen, and has initiated fact-based proceedings." Not that Genachowksi is afraid to get in the face of any company he thinks is being unfair to consumers. A month into the job, he wanted to know why Apple had rejected Google's free Internet telephone service as an iPhone app. Apple agreed to review the decision.

Genachowski has put a premium on communicating more openly with the public and industries the FCC regulates. The commission has just relaunched its Web site, which is easier to navigate and features blogs by staffers. Among the hires for the 1,800-person commission, Genachowski brought back Blair Levin—his onetime boss at the FCC, who became a well-regarded communications analyst—to help him with the broadband plan. Levin could be appointed to one of the five commissioner seats. Genachowski has also recruited a top Microsoft executive, a retired Navy admiral, the founding editor of *Consumer Reports*' Web site, and Yul Kwon, a former McKinsey consultant and winner of the CBS reality show *Survivor: Cook Islands*. "It's essential that I be in the room with a team that has a broad range of professional experiences," Genachowski says.

As part of the stimulus package approved last year, Congress set aside about $7 billion to expand broadband. While it is the most money the U.S. has allocated to that purpose, the sum is widely deemed inadequate if the U.S. is to catch up to other countries. Genachowski has a few ideas on how to supplement the stimulus money. One is to convert a fund set up years ago at the FCC to finance phone service in rural areas. He is also looking at ways to improve Web surfing on smartphones, netbooks, and other mobile devices. The challenge is finding enough wireless spectrum to handle the explosion of demand for streaming video and other bandwidth-hogging services. Genachowksi warns it could take anywhere from 6 to 12 years to free up enough spectrum.

Genachowski's effort to finish the broadband blueprint by next month has him attempting to make time for his wife, Rachel Goslins, a documentary filmmaker, and three kids. Plus, he still needs to write rules to enforce so-called Net neutrality—requiring Internet service providers to give equal access to all content. "He is saying all the right things," says Ben Scott, a policy director for Free Press, a nonprofit FCC watchdog that focuses on topics like diversity in media and Net neutrality. "We are waiting for him to deliver." | BW |

ILLUSTRATION BY SHAWN BARBER



THE WASHINGTON POWER GRID

Cass Sunstein

Regulation Czar

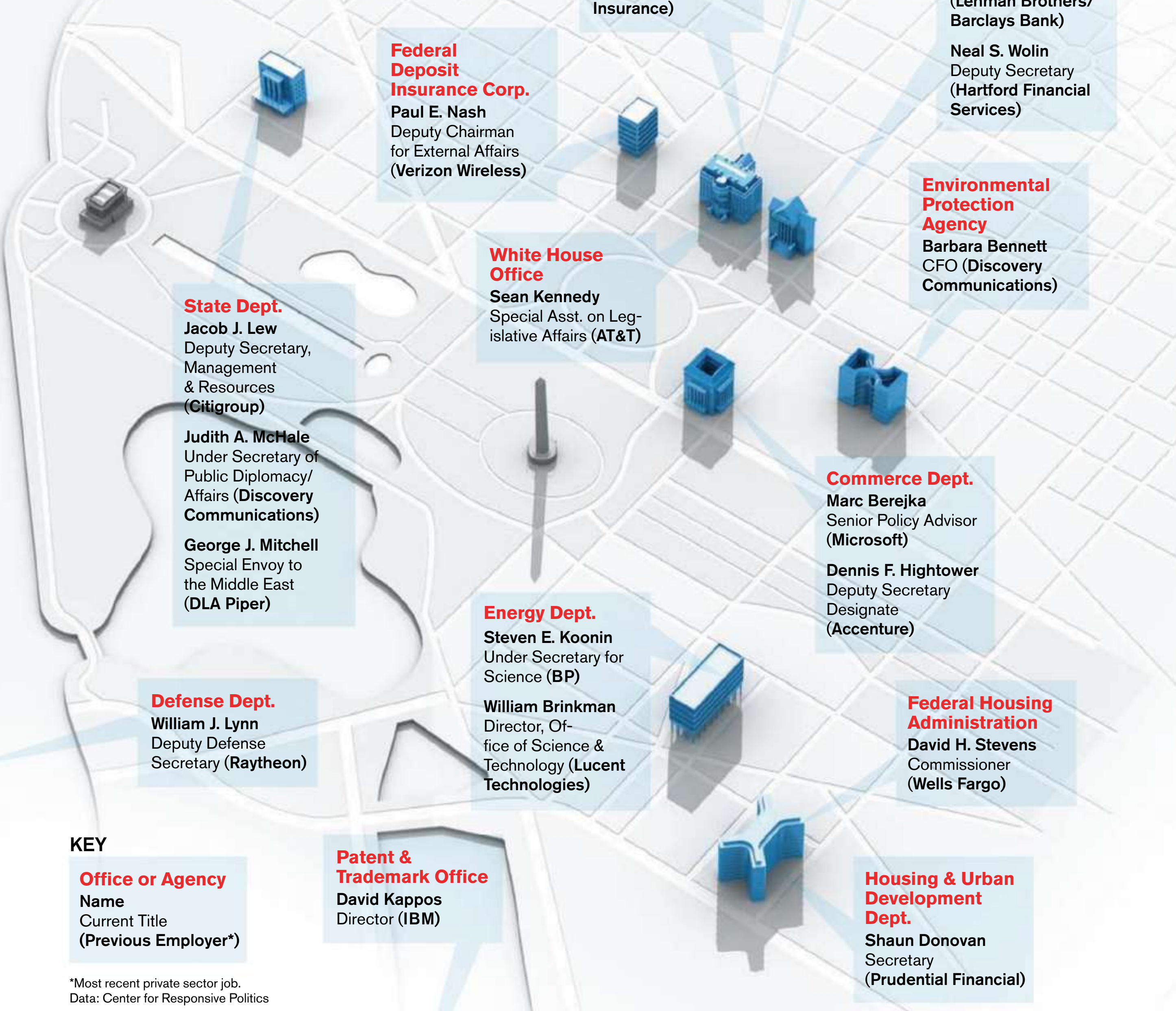
As a law professor at the University of Chicago and Harvard, Cass R. Sunstein wrote hundreds of articles on issues ranging from workplace regulations to the legal rights of animals. When Barack Obama nominated his friend to head the Office of Information & Regulatory Affairs (OIRA), which wields enormous power as the White House's arbiter of regulations, Sunstein's writings got him into trouble. The left feared his belief in cost-benefit analysis would lead him to quash environmental and labor rules they wanted. Conservatives painted him as a radical anti-gun, animal rights wacko. He lowered his profile and was confirmed by the Senate in a 57-40 vote. He's still plenty ambitious, taking on such issues as climate change and chemical regulation. Government officials say his demands for rigorous science have helped make some of their rulings, such as the EPA's finding that greenhouse gases endanger the public health, more defensible. He's half of a Washington power couple: His wife is Samantha Power, a Harvard professor who serves on Obama's National Security Council. They met during the Obama campaign and had their first child, Declan Power-Sunstein, in April.

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The Business Of Politics

Many Obama Administration staffers boast ties to the private sector.

By Tara Kalwarski
Map by Bryan Christie



Executive Office of the President

Michael Froman
Deputy Asst. to the President (**Citigroup**)

Valerie B. Jarrett
Asst. to the President (**Chicago Stock Exchange**)

James L. Jones
National Security Advisor (**Chevron**)

Treasury Dept.

Matthew Kabaker
Deputy Asst. Secretary (**Blackstone Group**)

Mark A. Patterson
Chief of Staff to the Secretary (**Goldman Sachs**)

Jake Siewert
Counselor to the Secretary (**Alcoa**)

Kim N. Wallace
Asst. Secretary, Legislative Affairs (**Lehman Brothers/ Barclays Bank**)

Neal S. Wolin
Deputy Secretary (**Hartford Financial Services**)

First Lady's Office

Desirée Rogers
White House Social Secretary (**Allstate Insurance**)

Federal Deposit Insurance Corp.

Paul E. Nash
Deputy Chairman for External Affairs (**Verizon Wireless**)

Environmental Protection Agency

Barbara Bennett
CFO (**Discovery Communications**)

White House Office

Sean Kennedy
Special Asst. on Legislative Affairs (**AT&T**)

State Dept.

Jacob J. Lew
Deputy Secretary, Management & Resources (**Citigroup**)

Judith A. McHale
Under Secretary of Public Diplomacy/ Affairs (**Discovery Communications**)

George J. Mitchell
Special Envoy to the Middle East (**DLA Piper**)

Commerce Dept.

Marc Berejka
Senior Policy Advisor (**Microsoft**)

Dennis F. Hightower
Deputy Secretary Designate (**Accenture**)

Energy Dept.

Steven E. Koonin
Under Secretary for Science (**BP**)

William Brinkman
Director, Office of Science & Technology (**Lucent Technologies**)

Defense Dept.

William J. Lynn
Deputy Defense Secretary (**Raytheon**)

Federal Housing Administration

David H. Stevens
Commissioner (**Wells Fargo**)

Patent & Trademark Office

David Kappos
Director (**IBM**)

Housing & Urban Development Dept.

Shaun Donovan
Secretary (**Prudential Financial**)

KEY

Office or Agency
Name
Current Title
(Previous Employer*)

*Most recent private sector job.
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Taxes: Ready to Rumble

How Obama will target business, and how business will fight back

By Jane Sasseen

Photograph by Stephen Voss

If you thought the fight over health care was tough, wait until the White House tries to raise corporate taxes. ¶ The budget deficit, bloated by the costs of President Barack Obama's stimulus plan and the sharp fall in tax receipts due to the recession, will hit $1.4 trillion in fiscal 2010, for the second year running—more than twice what it was in 2008. If Obama sticks to his pledge to keep the Bush tax cuts for families earning less than $250,000 a year, the move will add a projected $230 billion a year on average to the deficit over the next decade. ¶ That leaves only one viable source for the hundreds of billions in extra tax revenue needed to sponge up all that red ink. With his Jan. 14 proposal to raise up to $117 billion through a levy on the nation's largest financial institutions, Obama took a stab at increasing corporate taxes. It won't be the last. "The pressure to raise more from the business sector will only intensify," says Anne N. Mathias, a tax policy analyst for the Washington Research Group. Few expect the Democrats to push hard for a big corporate tax hike before midterm elections, and the prospects for boosting any taxes just got a lot harder with the Democrats' stunning loss in Massachusetts. Yet Mathias and others believe the risks of a squeeze on companies will rise sharply by yearend, when Congress and the President will have to extend the Bush tax cuts for the middle class before they expire.

Corporate lobbyists are girding for a battle, especially over the lucrative tax breaks that U.S. multinationals get on their foreign earnings. Thanks to a massive pushback last year—some of it coming personally from CEOs such as IBM's Samuel J. Palmisano, Caterpillar's James W. Owens, and Cisco's John T. Chambers—the Administration backed down from its proposals to raise some $160 billion by hoisting taxes on U.S. companies' overseas profits. The multinationals were able to convince many in Congress, including prominent Democratic legislators like Senate Finance chair Max Baucus, that the proposed hike in taxes on overseas operations would make it harder to compete in global markets, since foreign rivals generally pay lower rates.



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The next hints of how Obama plans to press his tax agenda will appear in February, when the White House releases the 2011 budget. "We expect them to bring all [of last year's] proposals back" with only minor changes, says Ralph Hellman, head of government relations at the Information Technology Industry Council, a trade group. "They might even add a few other things to hit us up further."

The most disputed of those tax hikes would sharply limit companies' ability to defer taxes on income earned abroad until those profits are repatriated to the U.S. Another would reduce multinationals' power to lower U.S. taxes through favorable accounting of their foreign tax credits. A third proposal would end a complex maneuver that lets multinationals shift profits from high-tax countries to tax havens: It's been dubbed "check-the-box" because companies can effectively make some foreign subsidiaries disappear for U.S. tax purposes by checking a box on their tax filings.

SMALL ISN'T BEAUTIFUL

Because of those and other benefits, many U.S. multinationals pay far less than the statutory rate of 35%. According to a study by Jack T. Ciesielski, publisher of *The Analyst's Accounting Observer*, a newsletter for securities analysts, health-care and pharma companies in the Standard & Poor's 500-stock index paid a median effective tax rate of 22.7% in 2008; info tech companies paid 25.9%; and financials were at 29.2%. Many individual companies did even better. Ciesielski calculates that Pfizer paid an effective rate of 17%. A Pfizer spokesperson says that its effective rate was more like 22% after adjusting income for special items.

By contrast, smaller companies that have kept their operations largely in the U.S. don't benefit from those breaks, so they pay much closer to the full rate. Despite fierce corporate resistance, the Administration wants to rebalance the two sectors' tax burdens. The President and his economic advisers also argue that the tax code encourages companies to ship jobs abroad. "We are well aware of the competitiveness issues," says one high-ranking Administration official. "But we ought to insure that the tax incentives aren't skewed to favor production overseas." White House and Treasury officials declined to comment on specific corporate tax proposals in the budget, though they acknowledge some changes have to be made in their strategy. "We recognize that it's not credible to just recycle stuff that went nowhere last year," says the official. "But we think some of those ideas remain worthy of consideration, [and] some are more doable than others."

Rosanne Altshuler, co-director of the Tax Policy Center, says the "check-the-box" measure, considered by many to be the international practice most open to abuse, remains highly vulnerable. Peter R. Merrill, a former chief economist with the congressional Joint Committee on Taxation who is now with PricewaterhouseCoopers, believes the Administration could also target new areas. Take, for example, "transfer prices"—the internal prices a company sets when it transfers its own assets or knowhow to a foreign subsidiary. The IRS, suspecting that multinationals often use this method to shift profits to lower-tax locations, has stepped up enforcement of transfer-pricing rules. Stiffer new regulations could be next.

The multinationals are hardly standing down in the face of potential tax hikes. They're focusing their arguments on employment, a hot-button issue with the jobless rate at 10%. If you make U.S. multinationals less competitive abroad, they argue, their overall sales and profits go down, and that hurts everyone in their organizations. "You will lose jobs in the U.S.," says Kenneth J. Kies, a prominent tax lobbyist whose firm, the Federal Policy Group, represents General Electric and Microsoft. "That's the last thing we ought to be doing."

Instead, says Brigitte Schmidt Gwyn, who oversees tax policy for the Business Roundtable, competitiveness would be bolstered by reducing the 35% U.S. corporate tax rate—the

The Actual Tax Bite

Companies complain that the 35% U.S. corporate tax rate hurts competitiveness. But thanks to an array of breaks, many pay far less. Below, the effective median rate paid by various industries in 2008:

22.7%	25.9%	29.7%	29.2%	29.5%
Health Care	Information Technology	Materials	Financials	Energy
30.2%	28.9%	31.3%	28.1%	27.9%
Consumer Staples	Industrials	Consumer Discretionary	Utilities	Telecom

Data: The Analyst's Accounting Observer

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BEN LOWY/VII NETWORK/AP PHOTO

Senator Gregg has agitated for a deficit commission with clout

second-highest in the developed world. Accepting something closer to the 26% average among the 30 member nations of the Organization for Economic Co-operation & Development, in exchange for eliminating the biggest tax breaks, would benefit many companies. Obama has said he would consider such a trade-off, which resembles proposals made in 2007 by the head of the House Ways & Means Committee, Representative Charlie Rangel (D-N.Y.), to get the corporate rate down to 30.5%.

In a nod toward such a move, the President commissioned a task force led by former Federal Reserve Chairman Paul Volcker that, among other things, is looking at how to reform corporate taxes while ending the worst loopholes. The panel has solicited ideas from business on what breaks it could forgo in return for a lower overall rate.

The trouble is, few in business believe the Administration will do a "revenue-neutral" deal in which the money the corporate sector saves by paying a lower rate is balanced out by the new money raised by Uncle Sam when loopholes are finally closed. The notion that the business community overall would pay no more was key to Rangel's proposal, but the Administration has not backed the idea. The need for more revenue is just too huge—a point, say lobbyists, that Administration officials often make in private meetings. "Sure, they say they are open to broadening the base and lowering the rate," says the Technology Council's Hellman. "But they are also clear about their desire to raise another $200 or $300 billion." Lawrence Summers, Obama's top economics adviser, is also skeptical about claims that U.S. tax rates are uncompetitively high. "If you look at taxes paid by corporations as a fraction of profits, they are quite low relative to international standards and historical American standards," he says.

All this has left business executives convinced they remain in the Administration's sights. They vow not to get suckered again, as many believe happened in 1986, when Congress last did a major rewrite of tax rates. By the time negotiations for the 1986 act were over, Congress had hiked the corporate share of the tax take to pay for cuts for individuals.

Much of the business community is stonewalling. In their submissions to the Volcker panel, groups like the National Association of Manufacturers (NAM) have been reluctant to go beyond general support for tax reform. "If we say we're ready to give up something to get lower rates, chances are they'd hear the first part but not the second," says Dorothy B. Coleman, NAM's head of tax policy.

THE PRESSURE BUILDS

In Congress, the Republicans—and middle-of-the-road Democrats chastened by their party's growing unpopularity—will hesitate to back any tax increases without serious spending cuts. "We see the fiscal problems as more driven by spending," says a top aide to one Republican member of the Senate Finance Committee. "If the purpose of any tax reform is to come up with more money, it will be very hard to get bipartisan support." Under pressure from Senators Judd Gregg (R-N.H.) and Kent Conrad (D-N.D.), the White House and Democratic leaders have agreed to form a bipartisan commission that would recommend ways to rein in the deficit. Whatever grand bargain the commission might reach to hike taxes and cut spending would not be made public until after the midterm elections, and Congress would vote on the package in its entirety. Backers argue that this would provide the political cover needed to make tough decisions—though Gregg blasted the Democratic plan as too weak to be effective.

Rangel, too, is angling to revive his reforms. Now he's pushing to drop the corporate rate to 28%. "There is tremendous potential for simplifying the corporate tax code and lowering the rate further," he says. Adjusting depreciation schedules to slow writedowns would help a lot, he argues. So would ending $31 billion in tax breaks for the oil and gas industry—another stalled Administration proposal likely to return. To date, Obama has shown little interest in Rangel's latest ideas.

With the loss of their filibuster-proof majority, Democrats will face an even tougher task getting any tax hike through the Senate. Still, the savviest lobbyists are quietly preparing for the day a "just say no" strategy doesn't cut it. The head of one major trade association, who played a key role in stalling Obama's tax proposals last year, has begun meeting with members to figure out, when forced, "what our bottom line is—what would we be willing to give up?"

The pressure is steadily building. Already, the House wants to end the current tax treatment of the "carried interest" earnings of private equity fund managers, which allows them to pay capital gains rates of 15% rather than higher income rates. The Administration is likely to pick up the cudgel on this one, too. As one House aide to a prominent Democrat puts it: "[Companies] had better engage, because a lot of these items will be taken away anyway." |BW|

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Obama Still Moves The Merch

His approval rating is down, but tourists—and critics—are keeping his memorabilia market hot

By Burt Helm

Last January, fans of President Barack Obama swarmed the Inauguration Superstore in Washington, which obligingly ran 18 cash registers until midnight. Now the 6,000-square-foot shop, renamed Washington DC Souvenir Headquarters, makes do with piles of deeply discounted Obama T-shirts, two registers, and few customers. On a recent Monday, manager Aisha Williams started to blame the slow business on cold weather. Then she corrected herself: "Last year people were willing to freeze for Obama."

Few U.S. Presidents have inspired the fanatical admiration that Obama once did. And none save one, Ronald Reagan, saw his approval rating sink as low—to 49%, compared with Obama's 50%—by the end of his first year in office, according to Gallup. So while there are no reliable estimates of the exact size of the Obama memorabilia market, it's no surprise that sales of Obama gear, everything from clothing to condoms, have fallen significantly from a year ago. Yet veteran souvenir manufacturers and retailers say that, boosted by sales to foreigners and those with a fanatical dislike of the President, Obama swag continues to be a strong seller for souvenir vendors. The man still moves merch.

James Warlick, who owns Washington's two Political Americana souvenir shops, reports that Obama gear makes up 40% of his nearly $2 million in annual sales; since setting up shop in 1989, ephemera related to sitting Presidents has typically contributed 15% to 20% of sales. "Tourists from Germany, Australia, France, will come in and buy 10 of one thing to take back home," says Warlick. Lissa Ongman, 30, an American researcher of chimpanzees living in Côte d'Ivoire, recently stopped into Political Americana to pick up Obama stickers for her Ivorian staff. "They still love Obama," says Ongman.

Jane Crawford, owner of the 21-store America! chain of souvenir shops, says Obama memorabilia is outselling that of any other sitting President since she went into business in 1988. In her outlet in Washington Dulles International Airport's international terminal, the best-selling item is an Obama "Hope" T-shirt. But at Dulles' domestic terminals, her best seller is a T-shirt reading, "Don't Blame Me! I Voted For McCain & Palin!" At online retailer CafePress, which puts customers' own designs on T-shirts, mugs, and other gift items, some 43% of Obama-related sales are for anti-Obama trinkets.

The continuing boomlet is enough to keep New York-based wholesaler N.G. Slater generating a couple hundred dollars' worth of sales in Obama buttons a week, even though his political business generally disappears shortly after an election. "The only thing I can compare it to is JFK," says owner Robert Slater, whose father made buttons for Franklin Delano Roosevelt's 1936 reelection campaign. David Shaw, co-owner of novelty item designer Unemployed Philosophers Guild, reports sales of his Obama items (top seller: Obamamints, at $3 a tin) totaled $85,000 in the fourth quarter of 2009, compared with $90,000 during the same period in 2008.

The enduring appeal of Obama gear doesn't surprise William L. Bird Jr., the curator of the Politics & Reform Div. of the Smithsonian and collector of Obama memorabilia for the museum. Bird points out that the President is not only young and attractive but fits effortlessly into popular culture. "The fact you could have something like this," he says, waving a campaign button featuring Obama with teen pop star Hannah Montana as his running mate, "that's gold for a politician, and gold for guys selling stuff with his name on it." | **BW** |

The President's image has graced everything from nesting dolls to condoms

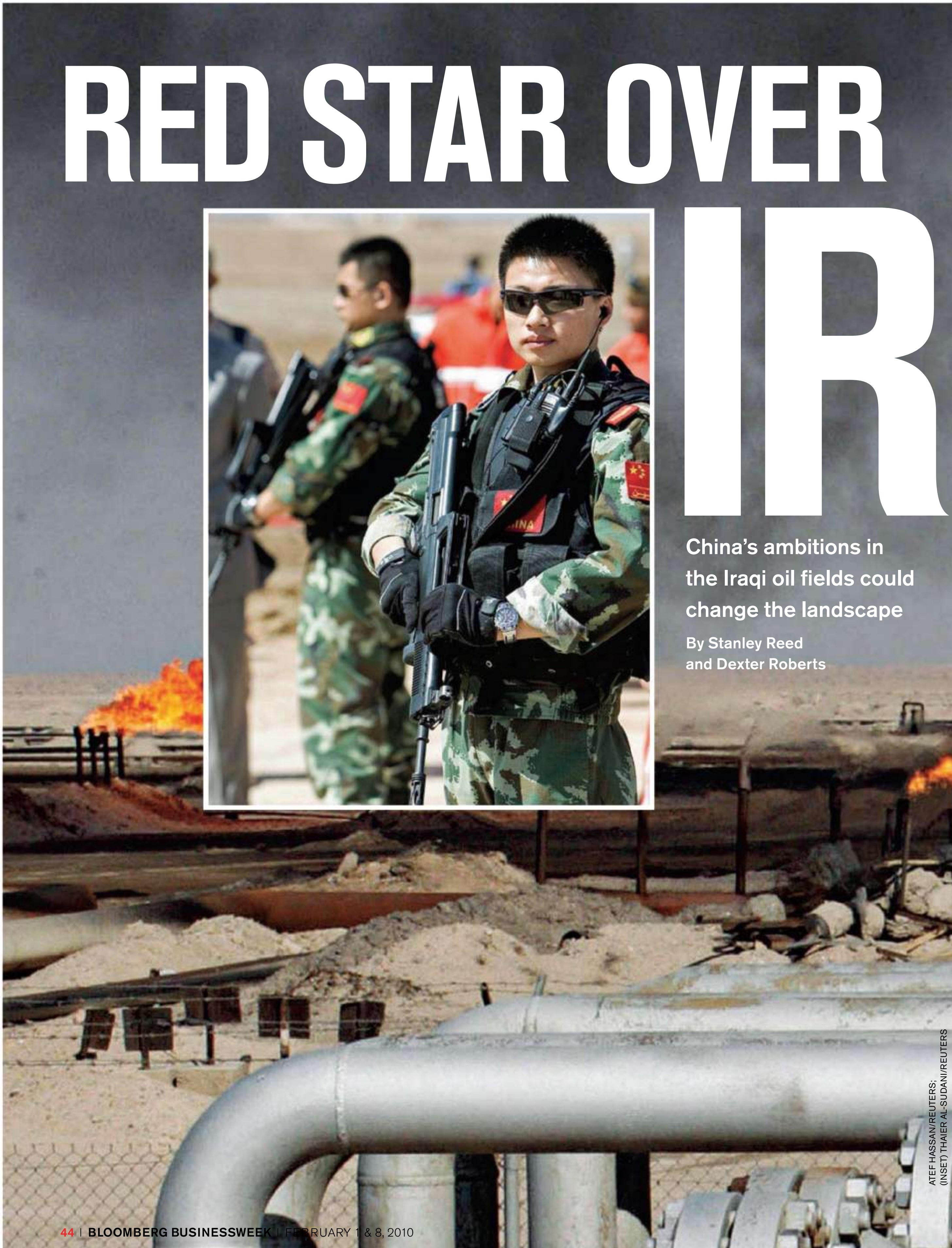


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RED STAR OVER IR

China's ambitions in the Iraqi oil fields could change the landscape

By Stanley Reed and Dexter Roberts

ATEF HASSAN/REUTERS; (INSET) THAIER AL-SUDANI/REUTERS

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AQ

It may be the start of the biggest oil job in the world. Each day, 20 workers from BP and China National Petroleum Corp. (CNPC) buckle down to the task of prepping the Rumaila oil field in southern Iraq for rapid development. In industry lingo, Rumaila is a "supergiant"—a 50-mile-long deposit of sweet crude with estimated reserves of 16 billion barrels, whose output may someday rank second only to Saudi Arabia's vast Ghawar field. The Saudis, though, have carefully managed their oil assets for decades. In contrast, Rumaila, a lightly inhabited expanse of date groves and Bedouin encampments, has not had

An Iraqi worker (below) at the Rumaila oil field: Chinese guards (left) at the Ahdab field

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CHINA IN IRAQ | Recent pacts to develop Iraqi oil fields

FIELD/RESERVES	DEVELOPER/SHARE OF VENTURE	TARGET PRODUCTION
Rumaila 16 billion	BP 38%, CNPC 37%, South Oil 25%	2.85 mbd*
Halfaya 4 billion	CNPC 50%, Total 25%, Petronas 25%	0.54
Ahdab 1 billion	CNPC 100%	0.10

*Millions of barrels per day Data: Wood Mackenzie, Iraqi government

a proper upgrade since the 1970s. The Iraqis contracted with BP and CNPC last year to juice Rumaila's production from 1.06 million barrels a day to 2.85 million, all in seven years. No one has ever tried such a ramp-up at a field as huge as this one. Putting Rumaila back in full working order will take tens of thousands of workers, 1,000 new wells, and billions in investment.

BP is the largest partner in the venture, but only by a dipstick: It has a 38% stake, while the Chinese hold 37% (the rest is owned by an Iraqi company). The media focus has been on BP's decision to take up the Rumaila challenge for a low fee of only $2 for every barrel the venture produces. But the more important story could be China's role. "CNPC's involvement brings together the country with the most rapid growth in energy demand in history with the country that plans the greatest buildup of production capacity ever," says Alex Munton, an Iraq specialist at Edinburgh-based oil consultants Wood Mackenzie.

China has moved fast. In a little over a year, CNPC, China's main oil producer with revenues of more than $188 billion and a 1.5 million-worker payroll, has won large stakes in three Iraqi oil fields. The total production target for those fields is around 3.5 million barrels per day—close to China's domestic output. In two of the ventures, China is the controlling partner. Over two decades or so, CNPC may spend some $20 billion on the fields, the most of any oil company in Iraq since Saddam Hussein fell. For China's oil industry, "Iraq is a game-changer," says Wenrang Jiang, an authority on the country's energy thirst who teaches at Canada's University of Alberta.

TIED TO THE LEADERSHIP

Carved out of China's oil ministry in 1988, state-controlled CNPC managed the oil and gas fields of north China before expanding to Peru, Sudan (where it has been criticized for working with the regime), and Venezuela. It has a reputation as insular and bureaucratic, especially compared with China National Offshore Oil Corp. CNOOC, founded in 1982 with a mandate to drill in offshore locales with foreign companies, has executives who speak English as a matter of course and travel widely. "CNPC always viewed itself as a direct successor of the oil ministry," says Victor Gao, CNOOC's former general counsel and currently a private equity investor. "So it's more orthodox; it considers itself a government entity."

Jiang Jiemin, 54, who has run CNPC since 2004, is a man of few words. In Iraq, though, Jiang and his team played their hand well. Months before the Rumaila deal, CNPC got the rights to develop Ahdab, a medium-sized field. That means CNPC is one of a few outside oil companies with operating experience in Iraq. Jiang has also forged a good relationship with BP CEO Tony Hayward, who sees CNPC as the gateway to China. BP "wants to have them as a partner wherever they can," says Bob Maguire, head of oil and gas investment banking at Perella Weinberg Partners in London. "They are the largest NOC [national oil company] in Hayward's mind." CNPC declined to comment for this story.

SAFIN HAMED/AFP/GETTY IMAGES

AN OIL BOOMTOWN IN IRAQI KURDISTAN

Erbil is prospering, but tensions with Baghdad are increasing

By Ben Holland
ERBIL, IRAQ

Traveling from Baghdad to Erbil, you feel like you're entering a different country, which in a sense you are, since the city is the capital of Iraq's semi-autonomous Kurdish region. New homes stretch out onto the dusty prairie, and the main avenues are dug up as workers lay fiber-optic cables. In the bazaars, horse-drawn carts laden with pomegranate seeds and stewed beetroot jostle with men selling mobile phones from motorbikes. "Every time I go, there are two or three buildings that weren't there before," says Andrew Eberhart, whose Marshall Fund, a U.S. private equity firm, runs a tomato-paste plant near Erbil that he visits several



In the shadow of Erbil's Citadel: Business is good and there is a mood of optimism

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BP and CNPC bring different strengths. BP has been studying the field by agreement with the Iraqis and already has worked out a development plan. And the Chinese? Beijing-based CNPC has access to affordable credit from China Development Bank and China Exim Bank. In an industry where supplies are tight, "they have spare capacity, rigs, and other equipment available that you could mobilize and put on the ground," says Andy McAuslan, BP's Iraq commercial director. (He adds that contracts for oil services in Iraq will be awarded competitively.) Fast deployment in Iraq is key. According to their contract, BP and CNPC won't start getting paid until they have boosted production 10%. The Chinese know how to manage thousands of workers in distant, often hostile locales such as Central Asia and the Sudan. It also knows how to develop onshore fields: In China, it pumps the equivalent of 3.3 million barrels a day. Besides the role in drilling wells and pumping oil, Chinese companies are good candidates to build the oil terminals, refineries, and pipelines Iraq will need to get its crude to global markets.

China is the low-cost provider in the industry. "As a general rule of thumb, Chinese management and labor costs are about one-third if not one-fourth of Western costs," says Gao, the ex-CNOOC executive. Nine colleges and universities focus exclusively on oil studies in China: "The Chinese treat the industry as a life-and-death issue," says Gao. The Western oil industry's workforce is aging rapidly. "Analysts always mention that the oil majors face personnel shortages," says Xu Xiaojie, an independent oil and gas adviser in Beijing. "In China we have a surplus."

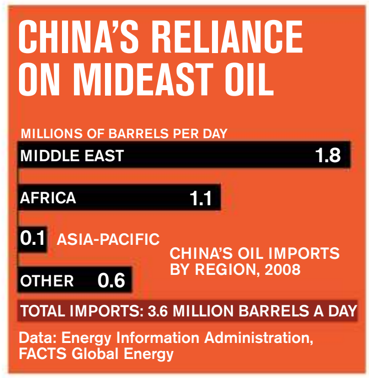


CHART BY ALBERTO MENA/BW

The Iraq ventures still face formidable obstacles—sectarian strife, corruption, and government instability, among them. The Iraqis also may not welcome large numbers of Chinese to their fields. "Yes, bringing in low-cost engineers is China's advantage," says Trevor Houser, a partner at the Rhodium Group, a New York-based research firm that studies India and China. "But that has created tensions [elsewhere]. Look at Zambia, where an election was pretty much fought over China."

China and CNPC, though, have no choice. The Chinese are hungry for crude and for a position among the world's top oil companies. Iraq may prove the best place to satisfy both desires. |BW|

times a year. "There's a lot of energy."

As Baghdad steps up oil production, it might look north to this city for pointers on working with foreign investors. The Kurds have been awarding contracts to overseas companies since 2002, a year before Saddam Hussein's ouster. Today, Canada's Addax Petroleum (acquired by China Petrochemical), Norway's DNO International, and Turkey's Genel Enerji International have contracts for the Taq Taq and Tawke fields in Kurdistan. The Kurds say they could produce 200,000 barrels a day by the end of 2010—about 10% of Iraq's current output—up from a maximum of 100,000 barrels daily last year.



The north's stability is strengthening the hand of Kurdish President Massoud Barzani as he bargains with Baghdad over oil resources. In the run-up to national elections in March, the Kurdish region—where nearly 20% of Iraq's 29 million citizens live—isn't shy about parading its autonomy: Police wear Kurdish uniforms. The region's red, white, and green flag is ubiquitous while Iraq's is nowhere to be seen. Kurdish parties will participate in the election, but Barzani isn't a candidate.

EXPORTS ON HOLD

The catch is, the Kurds can't sell their oil abroad without help from the government of Prime Minister Nuri al-Maliki, which controls export pipelines. Since the Kurds started oil exports in June, Baghdad has refused to pay the international companies for their share of the export revenue, saying Barzani's government had no right to sign its own contracts. That's "unfair and unreasonable and illogical," says Falah Mustafa Bakir, the region's de facto foreign minister. In October the Kurds suspended exports, and the region's output has slumped to 20,000 barrels a day.

While locals and foreigners alike praise Kurdistan for building up its infrastructure and welcoming investment, tension between the Kurds and Arab Iraqis remains a concern. Barzani says Kirkuk, the province southeast of Erbil that produces a quarter of Iraq's oil, should be part of Kurdistan. A local referendum on that question has been delayed for two years, and both Barzani and Maliki have built up military forces in the province. "If you clash with your neighbors, it's difficult for investors to believe in the area," says Baz Karim, chief executive of Kar Group, an Erbil company with $1 billion in energy and building contracts.

Nonetheless, there's a mood of optimism in Erbil. Karim is building a 13-story tower in the city as Kar Group's headquarters and is expanding Kar's oil refinery. The boom marks a dramatic shift from the 1980s, when Hussein's troops killed thousands of Kurds, and the impoverished 1990s when the region was cut off from the rest of the world. "A few years ago there was no money, no electricity, no banks," says Dara Jalil Khayat, head of the Erbil Chamber of Commerce, whose glass-fronted offices stand out against the 6,000-year-old mud-brick Citadel that looms over Erbil's center. "Now we have lots of industry." |BW|

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KING OF THE WORLD (AGAIN)

By Ronald Grover, Tom Lowry, and Michael White

The inside story of how *Avatar*'s James Cameron became the most powerful commercial force in the movie business—twice

Reasonable people can debate the artistic merits of James Cameron's work. Anyone for whom Arnold Schwarzenegger is a frequent muse is not likely to specialize in observing the human condition, unless it's in the aftermath of an exploding building or a run-in with a mercenary robot from the future.

What's indisputable, however, is that the *Avatar* director's influence extends far beyond his movie credits. More than George Lucas or Steven Spielberg, Michael Bay or Pixar, Cameron is the most important commercial force in modern film, and his vision for the future of the movie

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With *Avatar*, Cameron has changed the economics of the movie business

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Cameron on the *Avatar* set: "I knew that if this failed my name would be dirt"

business is rapidly demolishing anything that gets in its way.

There are 1.64 billion reasons that Cameron is Hollywood's director of the moment—that figure being the mid-January worldwide gross of *Avatar*, the blue-aliened, 3D extravaganza that earned Golden Globes for best director and best dramatic picture. By the time you read this, *Avatar* may have passed the $1.84 billion mark set by 1997's *Titanic*, Cameron's previous feature and current holder of the title Highest-Grossing Film of All Time.

The money is impressive, but it only hints at Cameron's impact. It took *Titanic* several months to reach $1 billion worldwide at the box office. *Avatar* hit that milestone in 17 days. How? Because cinema operators say they can charge at least 30% more per ticket if a movie is in 3D. By persuading a huge number of filmgoers to put on the 3D glasses and pay more for the privilege, Cameron has changed the economics of the movie business. "Films can change people's minds, and the aim with *Avatar* was to introduce the industry to the possibilities of 3D," Cameron told *Bloomberg BusinessWeek*. "I decided, let's go make a movie that they can't ignore."

At 55, the man who declared himself king of the world at the 1998 Oscars has mellowed some. Cameron accepted his 2010 Golden Globes with a mix of humility and amazement. No one knows better than he how close *Avatar* came to not being made. Despite Cameron's track record for delivering large profits on big budgets, Twentieth Century Fox, which co-financed *Titanic*, hesitated to make an even riskier film that required the creation of a three-dimensional alien world. "I knew that if this failed my name would be dirt, but that's the nature of this business," says Cameron. "Every director knows that you can flame and burn like the Hindenburg, and do it very publicly."

With the studio balking, Cameron had to turn himself into an inventor-entrepreneur. Using his own funds, he devel-

(TOP) TWENTIETH CENTURY FOX/KOBAL COLLECTION

HOLLYWOOD'S MONEY MACHINE

James Cameron has directed several blockbusters over the past quarter-century, including the two top-grossing films of all time, *Titanic* and *Avatar*

1978



1984



1986



1989



Film	***Xenogenesis***	***The Terminator***	***Aliens***	***The Abyss***
Budget	$20,000	$6.4 million	$18.5 million	$69.5 million
Box Office	Not available	$78 million	$131 million	$90 million

Data: IMDB: Box Office Mojo; News Corp.

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oped the technology to bring *Avatar* to the screen, betting that what he saw in his head would be so visually persuasive that, ultimately, he could sell his souped-up camera rigs back to Hollywood at a potentially considerable profit.

Until *Avatar* came along, 3D movies—even such recent efforts as 2008's *Journey to the Center of the Earth* and 2005's *Chicken Little*—had the stigma of novelty. Now fellow directors, convinced their movies will attract a wider audience in 3D, are willing to pay Cameron to use his gear. *Avatar*'s technological wizardry also coincides with a big push by Sony, Panasonic, and other consumer electronics companies to bring 3D into the home with a new generation of TVs and DVD players. "This is a game-changer," says Rupert Murdoch, chairman and CEO of News Corp., which owns Fox. "If you create a film of this quality and make it an event, it shows that people will pay to come see it. We will see more [3D in] films and TV."

A VISION OF BLUE ALIENS

Cameron wrote the original script for *Avatar* in the mid-1990s. Set 150 years in the future, it told the story of a paraplegic ex-Marine who travels to a moon called Pandora where he inhabits the body of a Na'vi, the 10-foot-tall, blue-hued humanoids who inhabit the world's lush jungles. The marine falls in love with a Na'vi princess (think John Smith and Pocahontas) and ends up defending her people against Earthlings eager to exploit Pandora's resources. Even 15 years ago, Cameron had a fully formed vision of Pandora—right down to the blue aliens, six-legged mammalian predators, and floating mountains. But he put any plans to film his *Avatar* script on indefinite hold, knowing that the existing technology could not do justice to his ambitions.

By 2000 he was growing impatient. So Cameron contacted Vincent Pace, an entrepreneur who helped design and manufacture the underwater lighting system for Cameron's 1989 movie, *The Abyss*. Through his eponymous company, which develops and rents cameras for use in hazardous conditions, Pace agreed to work with Cameron on a camera rig that could capture 2D and 3D images simultaneously. Cameron says the project cost about $12 million, much of it his money.

It's a rule as old as Hollywood: Never sink your own money into a movie. Ultimately, Cameron felt his investment would be justified not only because it would allow him to make *Avatar* but also because the new technology would accelerate the rollout of 3D, giving theater chains an incentive to upgrade their projectors and screens and moviegoers an incentive to leave their increasingly well-equipped living rooms.

Developing the technology was one massive project. Cameron also had to persuade Fox to finance *Avatar*. Although the studio had backed and distributed several Cameron films, the *Titanic* experience had made Fox executives cautious. Originally budgeted at $110 million, the film's production costs famously ballooned to $200 million when special effects and the cost of constructing the ship delayed filming. There were also months of rumors preceding the film's release that it would prove to be one of the worst business decisions in the history of the movies. Given all that scary background, says Twentieth Century Fox Co-Chairman Tom Rothman, "*Avatar* couldn't be rushed." In 2005 the studio decided to place a small wager on Cameron—$10 million so he could show proof of concept.

With the Fox money, Cameron repaired to the 280,000-square-foot hangar he leases in Playa Vista, Calif.—where in the 1940s Howard Hughes built the Spruce Goose—and began working on a 3D film clip that he could use

2009


1991


1994


1997


T2: Judgment Day	***True Lies***	***Titanic***	***Avatar***
$102 million	$110 million	$200 million	$237 million
$520 million	$364 million	$1.84 billion	$1.64 billion*

*as of Jan. 20

(BOTTOM, FROM LEFT) NONE; ORION /KOBAL COLLECTION; TWENTIETH CENTURY FOX/KOBAL COLLECTION (2); CAROLCO/KOBAL COLLECTION; LIGHTSTORM/TWENTIETH CENTURY FOX/KOBAL COLLECTION; KOBAL COLLECTION; NONE

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to persuade Fox brass to make the movie. Jeffrey Katzenberg, CEO of DreamWorks Animation, says he and Cameron were in touch frequently during the experimentation phase and that Cameron visited the DreamWorks facility in Glendale, Calif., to learn more about animation software. "We create our own world in animation," Katzenberg says. "But this was the first time a director could take real characters and put them into a world he had created, in real time."

Katzenberg is one of Hollywood's leading cheerleaders for 3D moviemaking—higher-priced tickets and bigger audiences mean more money for his studio. While entertainment executives often root against rival projects, Katzenberg was hoping Cameron's movie would jump-start the revolution. "Everyone," he says, "was waiting for *Avatar*."

In October 2005, Cameron screened his 3D segment for four Fox executives at the offices of his production company, Lightstorm Entertainment, in Santa Monica, Calif. "Their eyes decided the best way forward was to try to persuade another studio to get involved. Walt Disney had produced two of the director's 3D underwater documentaries, so Cameron invited Dick Cook, then Disney's studio chief, to watch the clip. "We loved Jim and would have liked to have worked with him," says Cook. "He has an infectious love of 3D that impressed us. Unfortunately, we never got that far." The reason: Fox had the first right of refusal. "We were never going to let this one get away," says Fox Co-Chairman Jim Gianopoulos.

To get the deal done, the studio decided to bring in partners to share the financial burden. Fox already had a deal with Dune Entertainment, part of a New York private equity fund that since 2006 has contributed financing for Fox movies. To further reduce its risk, Fox began talking to London-based Ingenious Media, which since 1998 has raised $8 billion to invest in such films as *Shaun of the Dead*, *Night at the Museum*, and *Live Free or Die Hard*. Taking a stake in *Avatar*, however,



Cameron with Landau (second from right) and *Avatar* cast at the Golden Globes

kind of lit up," Cameron says. "They could see what I had been talking about for months." But *Avatar* producer and Cameron business partner Jon Landau says Fox still wanted a shorter script and a more reasonable budget. In response, says Landau, Cameron combined several characters to trim expenses. Cameron says he also agreed to cut his usual fee in half and take a lower percentage of the film's revenues if *Avatar* wasn't profitable. "Luckily," says Cameron, "we're at such a stratospheric level now that we're not worried about that."

By mid-2006, according to someone involved in the negotiations, Fox was still concerned that making *Avatar* would cost too much money. "They told us in no uncertain terms that they were passing on this film," Cameron says. Cameron required some persuasion. James Clayton, who oversees Ingenious' movie investments, recalls multiple meetings with Cameron and Landau in Playa Vista before deciding to invest an undisclosed sum. "I was really impressed by their understanding of the business, that there is so much competition these days for people's leisure time that you have to create something you won't find on TV, on computer games, the Internet, to draw audiences into the theater," Clayton says. "This wasn't purely a creative process for them, like it is with some producers. Jon and Jim absolutely understood the need to cater to audience tastes."

With Ingenious on board, Fox had lowered its exposure to less than half of *Avatar*'s $237 million budget. "We consider

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Cameron and Murdoch at the 1998 *Titanic* Oscar party in Los Angeles

all filmmaking a dangerous game," says Murdoch. "And we always lay off [risk] to the film funds when we can. This time we laid off more than usual. But we own much of the distribution and other rights. In the end, we will make much more money than them." In October 2006, Fox agreed to make *Avatar*. Cameron says he still isn't quite sure why Fox finally jumped aboard but recalls studio executives saying: "We don't get the giant blue guys with the tails, but we believe in you and want to do this movie with you." Months earlier, Cameron had put a traffic light outside Landau's office. After Fox said yes, they switched it from amber to green.

Production began, and word soon leaked out that something extraordinary was going on in Cameron's airplane hangar. The director had rigged the ceiling of the cavernous space with cameras that tracked his actors, who were wearing versions of the motion-capture suits made famous by the character Gollum in Peter Jackson's *Lord of the Rings* trilogy. Headsets rigged with tiny cameras captured actors' facial expressions and eye movements, a jolt of reality that Cameron deemed crucial if he was going to make the film. Using software developed in-house, the crew imported the actors into Pandora's digital world while Cameron was shooting.

THE 3D STAMPEDE

Before long, other directors began making pilgrimages to Playa Vista. Landau recalls visits from Spielberg, Ridley Scott, and *Pirates of the Caribbean* director Gore Verbinski. Landau even set up a screening room near the set so visiting filmmakers could watch on a monitor what Cameron was seeing in real time through the lens of his camera. In December producer John Davis (*I, Robot*; *AVP: Alien vs. Predator*) screened *Avatar* at a special VIP showing in Hollywood. "I saw how 3D could improve a film," he says. Davis hopes to persuade Fox to shoot a remake of the 1963 movie *Jason and the Argonauts* in 3D. *Transformers* director Michael Bay and *Star Trek* director J.J. Abrams have said they would like to convert their franchises to 3D, too, though Paramount has not yet agreed.

Not every movie will warrant the investment that 3D demands. For the foreseeable future it will remain a high-risk, high-reward medium that excludes Woody Allen movies, and Sandra Bullock ones, too. But for directors and producers of action and fantasy films, 3D has to be a consideration. "What *Avatar* showed is that there is still a reward in taking the risk to make a large-budget film that will bring people out of their homes," says former Fox studio chief Bill Mechanic, who produced the 3D *Coraline* in 2009.

Vincent Pace has had a steady stream of inquiries since *Avatar* was released. His company rents out its 3D cameras and associated gear to other directors at a rate of $1.4 million to $3 million per film, depending on the difficulty of the shoot. Director Joseph Kosinski is using one for *Tron Legacy*, which is due out in December.

Pace says advertising agencies have also expressed interest in using the camera rigs for commercials, and networks are eyeing it for 3D TV sports broadcasts. "The perfect storm has kind of swept by," says Pace. "We're quite excited that what we embarked on 10 years ago is being accepted in a very commercial way." Pace says he and Cameron own the patents on the gear and that, given the buzz generated by Avatar and the coming wave of 3D TVs, it won't be long before they recoup their initial investment and start to reap a profit.

As Cameron anticipated, *Avatar* has theater owners rushing to equip more of their cinemas with 3D technology. "*Avatar* has put an exclamation point on what we have done and what we are going to do," says Michael V. Lewis, CEO of RealD, a Los Angeles company that supplies 3D screens, projectors, and glasses to theaters. Of the 38,000 screens in the U.S., only about 3,600 are currently 3D-ready. Lewis says RealD plans to add an additional 5,000 screens in the next 18 months.

The director has emerged from his 12-year odyssey far more powerful than after his previous box-office record-breaker. Even with credit still tight, money almost certainly will flood his way. And like any good businessman, Cameron will put his development costs to work with brand extensions. In other words, look out for that *Avatar* sequel. | BW |

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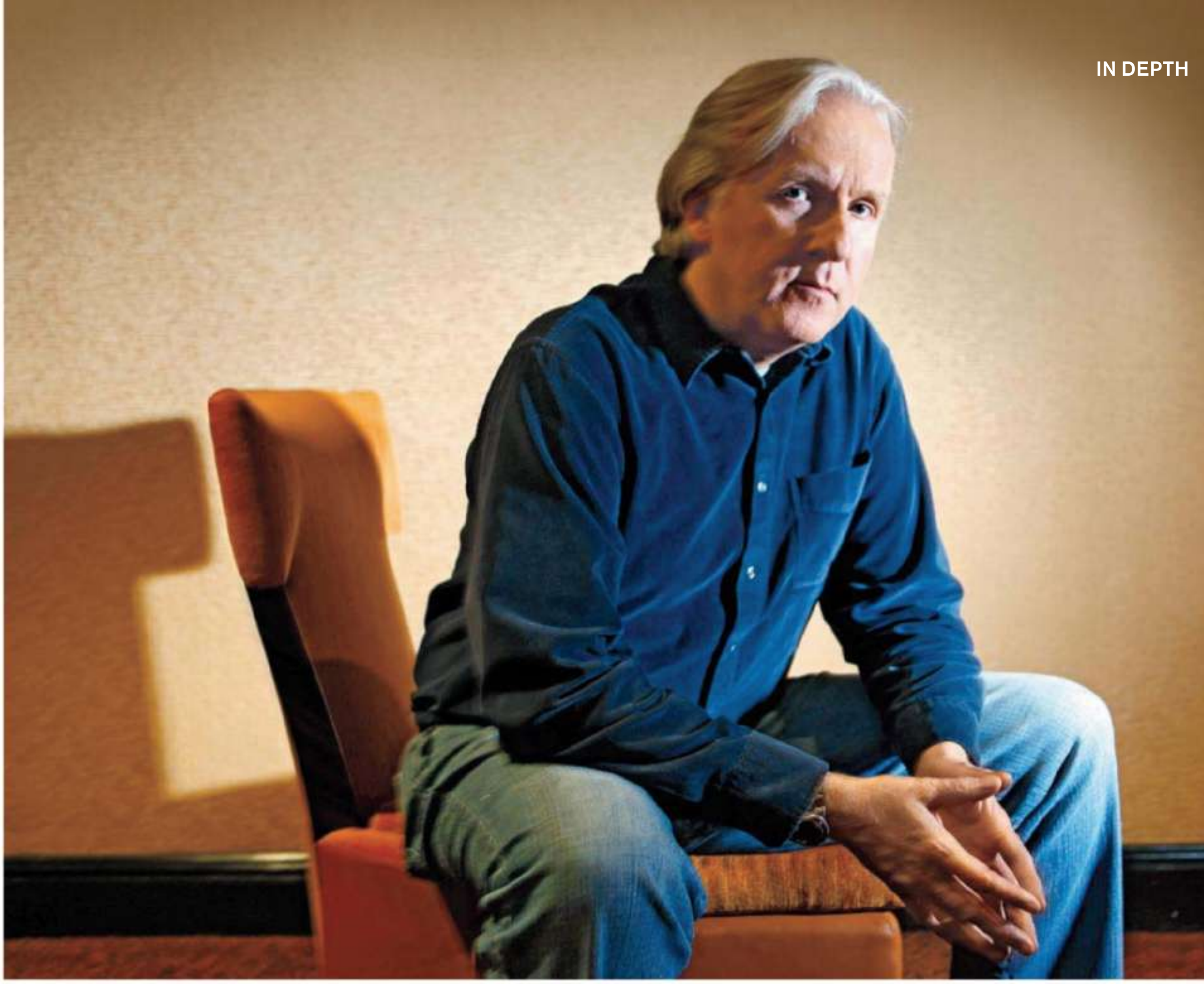
Cameron Redux

James Cameron's exploits have been well documented. Nonetheless, a profile of the director that ran in the Oct. 26 issue of *The New Yorker* is a fascinating read. The finely textured piece by Dana Goodyear traces the arc of Cameron's career from his roots in a small Canadian town to his present role as the king of Hollywood.

To read *The New Yorker* profile, go to **http://bx.businessweek.com/movie-industry/reference/**

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CHRIS CARLSON/AP PHOTO

INTERVIEW WITH THE AV-AUTEUR

Cameron on the blockbuster rocking Planet Earth

Shortly after the release of *Avatar* in December and again on Jan. 20, Charlie Rose talked with James Cameron. Below are edited excerpts of their conversations.

Did you have any idea how big *Avatar* would be?
We didn't see this coming. First of all, there is the critical success, which I certainly was not counting on. I thought it would be spotty at best just because of the history of science fiction. And then the commercial success. We had assumed we would probably come close to making money because we spent a lot.

What, about $230 million?
It was in that very, very general range. I don't want to commit to a number. I figure if the studio wants to announce a number, that's fine. We were actually fairly smart about the marketing. We brought in a number of promotional partners to help hold down the actual out-of-pocket marketing costs. We did that with McDonald's, Coke Zero, LG, and Panasonic. But even so, we knew we had to perform in the kind of $750 million-plus range to be profitable. And we knew what the negatives were: We didn't have stars, there was no prior art, it wasn't part of a franchise, and it wasn't adapted from a novel or a graphic novel or something that had any hook in the public consciousness. So we had to build all that from scratch. In the back of my mind, I always knew that the one gambit you have when you have a high budget and lots of time is you can make a great movie. And if you can engage an audience, especially a global audience, with a film that sort of transcends language, transcends the immediacy of the pop culture of America, and speaks to more universals of human emotion, human imagination—if you can do that, you can sort of break through and become an event, whatever that means. And I think *Avatar* did that.

What will it change?
One thing that I can point to right now as a likelihood is that, because of the financial and critical success, filmmakers who were reluctant to jump into making 3D films may be given a kind of permission that they didn't feel they had before—permission from the critical community that a serious

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filmmaker can do a piece of drama for grown-ups and not an animated film for kids, and they can do it in 3D and they don't have to feel guilty about it or feel that they're committing career suicide.

[Sony CEO Sir] Howard Stringer told us a couple of weeks ago that the entire emphasis of Sony at the Consumer Electronics Show was going to be 3D television. And they are gearing up because they helped you make the cameras.
There's an interesting history there because about six or seven months ago I had a closed-door secret presentation to Howard Stringer of a new business venture, and I mapped out what I believed was going to be the future of 3D and how many television sets were going to be entering the home and how there would initially be a dearth of 3D content and blah, blah, blah. I basically mapped out an entire strategy that he promptly announced a week later at the Sony stockholders' meeting. His speech was pretty much culled verbatim from my presentation. So thank you, Howard.

That's the sincerest form of flattery.
A more sincere form would have been to actually make the deal I was proposing.

Is 3D going to revolutionize cinema?
I think 3D will have a part in keeping the cinema experience alive as opposed to watching something on a little screen like a laptop or a small portable device. The home experience was catching up with the theatrical experience and starting to kind of erode it in people's minds as the big, exciting, magical thing that you went to. And I think 3D is a way of getting us back to that.

What's more satisfying, the commercial success or critical success?
I would have to say the commercial success only as a metric of how well the film is communicating. We're reaching people—and we're reaching them in China and Japan and France and Germany and pretty much wherever this film is playing.

Someone said that Spielberg is about awe, and you are about romance.
I can't help myself. I'm romantic. Romance with teeth, you know.

Someone also said you set out to a make a blockbuster, and you made a chick flick.
That was true of *Titanic*, and it may be true of *Avatar*. This film is a romance. It's an alien romance. Guy falls in love with a 10-foot-tall, hot blue chick on another planet.

Reviewers have noted a reference almost to Iraq in terms of the war and terror in the film.



"3D IS A WAY OF GETTING US BACK" TO THE BIG, MAGICAL EXPERIENCE OF GOING TO THE MOVIES

I wrote this thing before the Iraq war, but it lined up beautifully, because I was making references in the first script I wrote to Vietnam and all the way back to the colonial period in the Americas. You know, human history is a series of invasions. One group invades another group. The militarily superior takes over and destroys the other culture, and so on. And we're seeing that in this film, but we're seeing it from the standpoint of the people who are getting invaded. And I think anybody who's going to take a position that a war is a right and moral path should understand what it feels like when it's an aggressive war and what it feels like to be invaded. We felt it here with 9/11.

And you believe in just wars as President Obama expressed in his Nobel acceptance speech?
Yes, I believe in just wars. But I think we have to make the distinction, and that's where we as citizens in a democratic society have to be on our toes and have to be well-informed and have to have a voice.

Do you expect this to be the largest-grossing film ever made?
I think it will be as of this week, actually. It's pretty much a done deal, unless a comet hits the earth.

What do you think it'll make overall at the end?
It's hard to predict, but I think we'll definitely get past $2 billion.

And if you win the Academy Award ...
I have to get nominated first. I don't like to put a curse on it by even talking about it.

If you win, what will be bigger than "King of the World," which was your self-description when *Titanic* swept the boards? King of Pandora?
You know, that was my kind of boneheaded attempt to connect with fans of *Titanic*, since it was such a prominent line in the film. But I'm not saying this from a kind of been-there, done-that position, but from a position of somebody who desperately does not like to stand up in front of large crowds of people. And pretty much the biggest crowd of people that Hollywood knows how to assemble for any moment of human interaction is the Academy Award audience of a billion people. I remember thinking at the moment they were opening the envelope [when *Titanic* was nominated]: "Please don't let it be us. Please don't let it be me." And you get to that place. You really do. It's funny. It's almost more trouble than it's worth. And having done it already, I kind of feel like, "Well, *Avatar* doesn't need this." But on the other hand, I see the pride on the part of my editors and my effects people and my actors. And I think, "You know what, this can't be bad." |BW|

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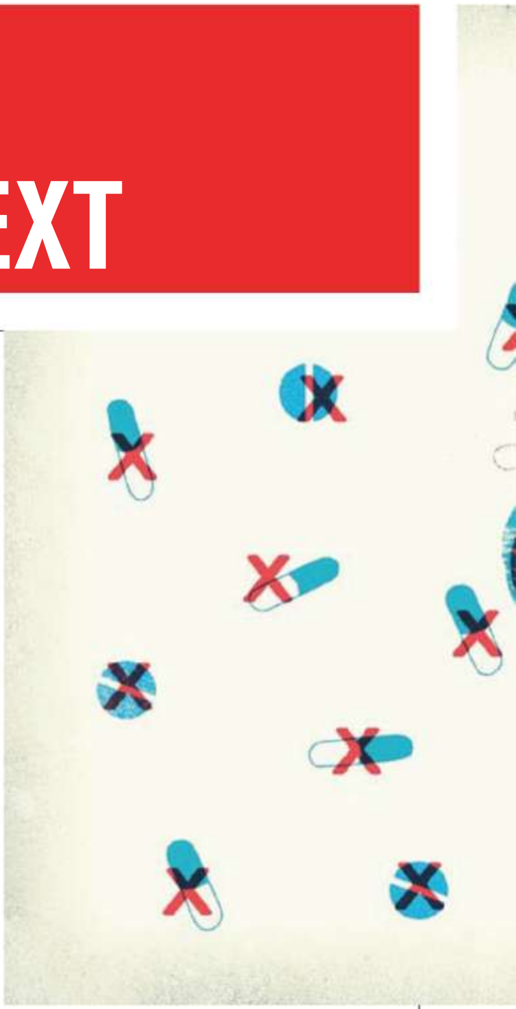
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WHAT'S NEXT

INNOVATION & TECHNOLOGY

Good for What Ails Only You

Gene-based services may finally make personalized medicine a reality—and vastly lower drug costs



CHRIS SILAS NEAL

By John Carey

The dirty little secret about drugs is that they only work in about half of the people who take them. So says an educational nonprofit called the Personalized Medicine Coalition, and many drug executives concede as much. Of the $292 billion spent in the U.S. on prescription drugs in 2008, as much as $145 billion went to medications that didn't help individual patients, said Jerel Davis, project manager at McKinsey, at a recent conference. And billions more are being spent to treat adverse drug reactions and other complications. "When you look at the data, it's shocking," says Dr. Robert S. Epstein, chief medical officer at Medco Health Solutions, a $51 billion company that manages drug prescriptions for 60 million Americans.

Researchers know how to solve this problem. First, figure out the differences between those patients who respond to a drug and those who don't, then treat only to those who will benefit. But this personalized medicine approach "has been slower to develop than we thought 10 years ago," says Richard K. Schatzberg, CEO of Generation Health, a startup that offers targeted medicine services. Lack of enthusiasm in the drug industry is a big reason; companies would lose billions of dollars if only those who actually benefit were to use such blockbuster drugs as antidepressants, arthritis medicines, and cholesterol pills.

Now, however, the promise of personalized drug treatments appears more realistic, thanks to new players on the scene—and a new business model. The recent entrants are pharmacy benefit managers (PBMs) such as Medco

HIT-OR-MISS MEDICINE

Tailoring drugs to patients based on their DNA might eliminate billions of dollars in waste

	Alzheimer's	Asthma	Pain	Rheumatoid Arthritis*	Schizophrenia
Patients who are helped	30%	60%	80%	50%	60%
U.S. prescriptions (billions a year)	$1.5	$8.0	$14.1	$13.6	$9.5
Estimated waste (billions)	$1.1	$3.2	$2.8	$6.8	$3.6

*Includes all autoimmune diseases, but RA is the most prevalent
Data: Medco Health Solutions (based on Brian B. Spear et al., *Trends in Molecular Medicine,* 2001)

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he thought." The company's first foray into personalized treatments in 2002 foundered. Epstein wanted to do genetic testing on asthma patients to predict better which ones might end up in the hospital, "but I couldn't see the return on investment," he says.

The business case improved as scientists identified more genes linked to drug responses. For many medicines, enzymes produced in the liver are crucial. Some enzymes change drugs so that they are excreted from the body. Others convert drugs that have no effect when first administered into a medically active form. Because of variations in genes, these enzymes may work quickly or slowly or not at all. One example is tamoxifen, used to prevent breast cancer recurrence. In 20% of people, the enzyme that usually activates this drug is partially or completely ineffective, and the drug provides little or no benefit.

and CVS Caremark. Medco is testing patients for genetic variations that explain why they respond differently to drugs like warfarin, a widely used blood thinner, and tamoxifen for breast cancer. CVS Caremark has taken a majority stake in Generation Health and expects to launch a similar testing program in May. The move by the PBMs "is transformative," says Edward Abrahams, executive director of the Personalized Medicine Coalition, whose members include scientists, health-care providers, payers, and patients' groups. "We are talking about better care for millions of people and keeping costs down for employers, whose insurance costs are exploding. It could be the tipping point."

PBMs plan to make money by selling personalized medicine services to employers, which are willing to pay them higher fees for improved health outcomes and lower prescription costs. Medco and other PBMs also hope to win market share from their slower-moving competitors. "It is a differentiator for us," says Dr. Jane Barlow, vice-president for Medco's personalized medicine business. Plus, they expect genetic testing will increase the percentage of patients using certain cheaper generic drugs, thus increasing profits. Medco has signed up 200 employers to its program, representing 7 million people. "This has been the fastest adoption of a new program in Medco history," says Epstein. One early—and eager—adopter: IBM, which expects better health outcomes and cost savings, says Dr. Martin Sepulveda, an IBM vice-president for health matters.

SECOND OPINION

The idea took a long time to bear fruit at Medco, even though it was an obsession for Epstein, an epidemiologist by training. "Back in 2000, Rob Epstein explained to me this would change the face of medicine—and make all the pharmaceutical companies nervous," recalls Schatzberg. "It took longer than

A turning point for Medco came in 2005, when a Food & Drug Administration advisory committee recommended that genetic information be considered in making treatment decisions with warfarin. The blood thinner is widely prescribed to prevent clots, but it's notoriously difficult to get the dose right. "We know that we kill people with warfarin all the time," says Dr. Issam Zineh, associate director for genomics at the FDA's Center for Drug Evaluation Research. Too much warfarin raises chances of bleeding and strokes caused by bleeding; too little allows deadly clots to form. The cost of using the wrong doses is estimated to be in the billions of dollars per year. With a genetic test, doctors can determine if people will need more or less warfarin than the standard 5-milligram dose.

When Epstein looked at Medco's

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medical records of its million patients on the drug, he discovered something alarming: As many as 25% of them ended up in the hospital within six months of starting on warfarin. "Avoiding one hospitalization could underwrite the cost of the test for 100 patients," Epstein reasoned. Medco worked with the Mayo Clinic to measure the clinical benefits and cost savings from genetic tests for warfarin. The final data won't be released for several months, but Medco found that employers were eager to sign on for the testing service anyway. Now, when Medco sees a prescription coming in for warfarin, it recommends genetic testing to the doctor and patient. In Medco's experience, 67% of doctors and 82% of patients agree to testing.

"THE INCENTIVES ALIGN"

The next drug Medco personalized was tamoxifen. Identifying women who can't metabolize the drug into its active form and putting them on a different drug reduces the cancer's chances of recurrence—and the costs of future treatment. Coming soon is a test for another blood thinner, the blockbuster Plavix. Pinpointing those who benefit will enable Medco to keep more patients on the drug when it goes generic, instead of switching to a more expensive alternative that doesn't require a test. A bonus is that the results from any given genetic test are usually applicable to many drugs. The same variation that determines the response to Plavix, for instance, can help determine how Valium, heartburn drugs like Nexium, and the antidepressant Celexa should be used.

The PBMs' foray into individualized treatments "is where the business rubber meets the road," says Michael Stocum, managing director of consultant Personalized Medicine Partners. "The incentives align. Patients want to get the right drug, and payers are willing to pay if they get a benefit."

Targeting drugs to those who benefit will obviously cut revenues for some drugmakers. But the pharmaceutical industry itself has started to back away from trying to sell the same medicines to everyone, says former Pfizer drug researcher Dr. Bruce H. Littman, now president of consultant Translational Medicine Associates. "The blockbuster mentality is still in place, but drugmakers are coming around," he says.

If they don't, the FDA may not be pleased. In the future, the agency may balk at approving drugs that can't be directed to the right patients—and payers may decline to reimburse. Amgen, for one, strongly backs the use of a test for a gene called KRAS for its $8,400-per-month colon cancer drug, Vectibix. About 40% of people have a variation of KRAS that prevents the drug from working. Drugmakers "see a future business model where they just want all of the smaller market of appropriate patients," says Generation Health's Schatzberg.

Given these trends, the once overhyped idea of personalized medicine "is really starting to get legs," says Dr. Eric Topol, chief academic officer at Scripps Health. "The old way of giving therapeutics will be obsolete." | BW |

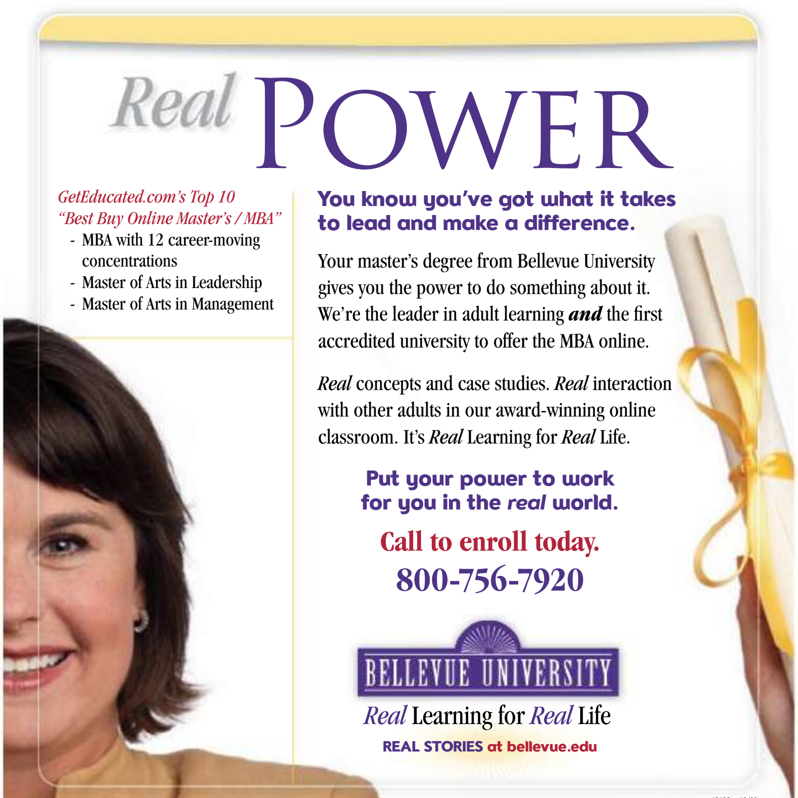
Business Exchange

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A Revolution—Or Not

The Language of Life, a new book from Dr. Francis Collins, director of National Institutes of Health, trumpets a revolution in personalized medicine. But Peter Aldhous, San Francisco bureau chief for *New Scientist*, finds the evidence thin. In a Jan. 7 entry on the New Scientist blog CultureLab, he calls Collins "a cheerleader for a revolution that hasn't arrived quite yet" and notes that many users of consumer gene testing services "have been underwhelmed by the insights gained."

For this and related articles, go to **http://bx.businessweek.com/genetic-testing/reference/**



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INNOVATION & TECHNOLOGY

The Last Hurrah of A Venture Capitalist

At the end of his career, NEA's Dick Kramlich wants to prove that megafunds can still pay off

By Tim Mullaney

Even some of Dick Kramlich's friends worry he's headed for trouble. The 74-year-old co-founder of the venture capital firm New Enterprise Associates just raised a new fund so large that many in Silicon Valley think he'll never be able to keep up with the returns at other top firms. NEA's $2.48 billion fund is 20 times the size of the average venture fund raised last year and is the largest launched since the financial crisis. Bob Ackerman, the founder of Allegis Capital who made his first fortune with Kramlich, says NEA's task would be tough in the best of circumstances and looks near-impossible now because it's so hard for venture firms to sell their startups through initial public offerings. "Big funds need big IPOs to generate a return, and those have been in short supply for a very long time," says Ackerman.

Such skepticism is widespread as the Valley legend begins his last act. Kramlich says NEA's 13th fund will be his last as a full-time partner, capping a career in which he helped commercialize everything from balloon angioplasty to PowerPoint. When it's over, he says, he'll have the last laugh. "With me, you're dealing with a different kind of cat," he says. "I don't have an ego. I have quiet confidence."



Kramlich plans to start a museum for video and audio art after his venture career

ERIC MILLETTE

Kramlich and NEA 13 are part of a broader debate about the best way to finance innovation. In the wake of the economic crisis and a sharp decline in startups going public, many experts believe the venture business has to get much smaller, shrinking individual funds and the total size of the $200 billion industry by as much as half. VCs like Ackerman, Greycroft Partners' Alan Patricof, and Netscape co-founder Marc Andreessen say the best approach is to put dabs of money into lots of tiny companies, quickly discarding ideas that flame out and feeding those that work. They may initially invest $1 million in the average startup, rather than the $20 million NEA typically has.

Kramlich and his backers counter that startups need serious money if they're going to tackle the kinds of issues that boost the economy and raise living standards. A new drug can cost hundreds of millions of dollars to develop. Tesla Motors has raised $223 million to build electric cars. "If you're going to climb Mount Everest, you can't do it with gym shorts and sneakers," says Alan E. Salzman, chief executive of Vantage Point Venture Partners, a Tesla investor.

NEA took a year longer than expected to raise its 13th fund, largely because of Lehman Brothers' collapse, says Suzanne King, the partner in charge of fund-raising. Kramlich and his partners ultimately got the money by convincing institutional investors of their approach: They plan to hedge their bets on newly formed companies by also backing more-mature startups that have perfected their technology and will use NEA's cash to grow. The fund will focus on health care, energy, and tech companies, while looking for opportune deals in other sectors. "We wanted a diversified fund with a flexible strategy, and that's what these guys do," says Vince Smith, chief investment officer of Kansas' Public Employees Retirement System, which put $10 million into the fund.

NEA 13 made 15 investments before

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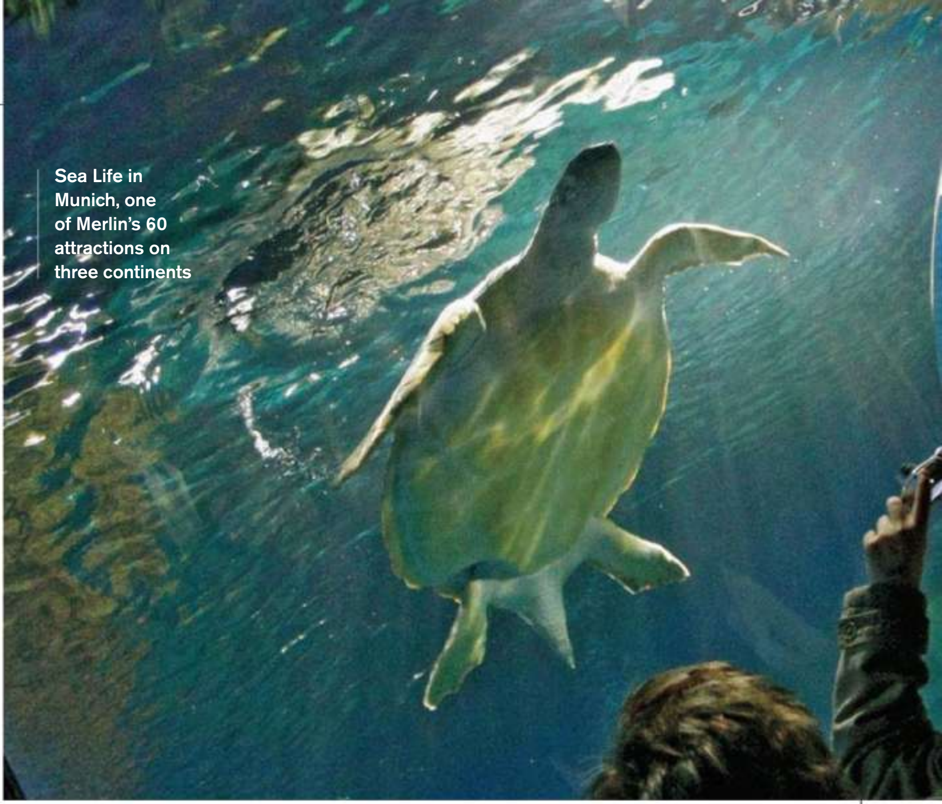
the fund closed in early January. The biggest was in Boulder (Colo.)-based Clovis Oncology, which plans to buy cancer treatments from inventors who lack the money or management skills to get them to market, says CEO Patrick J. Mahaffy. Clovis will run clinical trials, work with regulators, and handle marketing, splitting rewards with inventors. The NEA fund put $20 million into Montclair (N.J.) e-tailer Diapers.com, largely for marketing. It's also invested in social-networking and energy startups.

MATH PROBLEM

The challenge for NEA is the math, say advocates for smaller venture funds, such as Ackerman. Historically, venture firms have had to triple their money over 10 years to give investors top-notch returns. In a stock market where it's difficult to take even small companies public, that looks highly unlikely, say the skeptics. "Turning $150 million into $450 million is a lot easier than turning $2.5 billion into $7.5 billion," says Ackerman. He figures NEA needs its portfolio companies to be worth a total of $50 billion. "In one fund, you need 50 $1 billion exits? Or 200 $250 million exits? Has that ever been done?"

Still, big venture funds have done better than most others in the past. Of the 11 funds of $1 billion or more raised through 2005, all of them outperformed the average fund raised the same year, according to researcher Cambridge Associates. NEA has raised three funds of $1 billion or more, and all three rank in the top 30% of funds raised the same year, Cambridge says.

In the last stretch of his career, Kramlich is giving more responsibility to younger NEA partners and laying plans to build a museum for digital and audio art. But before he goes part-time, he wants to show he can thrive during what may turn out to be the worst stretch for the venture business in decades. "This season ... will validate we've built an organization equal to trying circumstances," he says. "The legacy I want is top-quality people and a top-quality institution that combines the venture art form with scale." |BW|



Sea Life in Munich, one of Merlin's 60 attractions on three continents

MICHAEL DALDER/REUTERS

STRATEGY & COMPETITION

Merlin's Amusement Park Magic

The attractions operator has become No.2 globally behind Disney, and an IPO may be in the works

By Mark Scott

LONDON

Among companies that run attractions designed for family fun, Merlin Entertainments Group is bigger than Universal Studios and Six Flags and second only to Walt Disney. But if you've never thought of Merlin beyond the mythical sorcerer, you're not alone. You do, though, probably know Merlin's attractions: Madame Tussauds wax museums, Legoland theme parks, the giant London Eye Ferris wheel across the Thames from Big Ben, and more. "No one on the planet has the brands that we have," Nick Varney, Merlin's 47-year-old chief executive, says in the original Madame Tussauds in London, where wax figures of Michael Jackson, Barack Obama, and Elvis eyeball one another across a room packed with camera-toting visitors.

"A KID LET LOOSE IN A TOY SHOP"

The big-name brands explain why Merlin is the fastest-growing major player in the business. The company is majority-owned by New York private equity giant Blackstone Group, which paid $195 million for most of Merlin in 2005. That year the company saw pretax profits of $28 million on sales of $87 million; by 2008 (the most recent data available) profits had hit $405 million and revenues topped $1.3 billion. "Sometimes I have to pinch myself. I

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feel like a kid let loose in a toy shop," Varney says as he prepares to jet off to Orlando to unveil a new Legoland at the site of the now-shuttered Cypress Gardens. Last year, Varney clocked more than 100,000 air miles keeping an eye on 60 attractions on three continents.

Investors are now hoping for a bit of Merlin's magic. Analysts believe an initial public offering of Merlin shares could raise some $3.3 billion. That would make it the largest listing on the London Stock Exchange in two years. While Varney won't comment, Nick Batram, a leisure analyst at brokerage KBC Peel Hunt in London, says there's mounting investor interest and reckons an IPO could happen as early as the second quarter.

It's little wonder that investors are eager to get a share of Merlin's growth. Visitors to attractions Merlin has owned for more than a year rose 17% in 2008, to 38 million, Merlin says. The industry worldwide saw attendance fall by 0.4%, according to Los Angeles consultancy AECOM, and analysts see a similar picture for 2009. Some rivals have fared far worse. As U.S. unemployment rose and consumer spending tumbled, Six Flags—which owns 20 amusement parks in 14 North American cities—filed for Chapter 11 bankruptcy protection last June. "Merlin is the rising star of the industry," says John Gerner, managing director of consultancy Leisure Business Advisors in Richmond, Va.

FISH AND FERRIS WHEELS

The key to Merlin's success is diversification. Like Disney, the company operates vacation resorts such as its bigger Legolands and Alton Towers, a combo theme- and water-park in northern England that boasts six roller coasters. These attractions rely on people traveling long distances and spending big bucks, so Merlin—along with other park operators—has been forced to offer discounted tickets and promotions such as cheap annual passes. But unlike its biggest competitors, Merlin also runs smaller attractions in Chicago, Washington, Munich, and elsewhere. Local families can spend a day there for under $100, which has kept them coming through the turnstiles even if they can't afford a trip to Disney World. "A museum, aquarium, or other family entertainment center is seen as good value for money," says John Robinett, a senior vice-president at AECOM.





CEO Varney with the gloved one at Madame Tussauds; the London Eye

That's certainly true for Merlin's Sea Life Aquarium in London. On a cold Saturday in January, more than 40 families speaking everything from English to Polish to Mandarin line up to see the riverside attraction, which the company bought in 2008. For $75, a family is treated to shark-filled tanks, pools teeming with stingrays and tropical fish, and talks on marine conservation. Merlin offers extras, such as kids' face painting for $5 and group photos for $15, that can easily add up to the entrance fee.

At the nearby London Eye, locals and tourists wait to pay the $80 for a family ticket that will take them 442 feet above the Thames for 30 minutes. "Even when the weather is bad, you've got to find something to entertain the kids," says Jeremy Butler, a 37-year-old accountant from central England visiting London with his wife and two children. "Compared to a holiday in France or Spain, the London Eye isn't that expensive."

London may be home, but Merlin is betting on city attractions well beyond its base. Four Madame Tussauds are in the U.S., a Legoland is coming to Dallas next year, and a $15 million Sea Life center is to open in Phoenix this spring. At the Meadowlands in New Jersey, Merlin plans to open a Legoland and operate a 287-foot-tall Ferris wheel, to be called the Pepsi Globe, with views across the Hudson to the Manhattan skyline. In Asia, Madame Tussauds is in Shanghai, Hong Kong, and (soon) Bangkok. A Legoland in Malaysia will open by 2012. "The U.S. and Asia are where most of Merlin's growth will come in the next five years," says Joseph Baratta, a senior managing director at Blackstone and a member of Merlin's management committee.

Analysts reckon Merlin could also buy parks, particularly if cash-strapped smaller locations in the U.S. go up for sale. "If you're a new kid on the block like Merlin, you've got to be out there staking your flags," says Dennis Speigel, president of consultancy International Theme Park Services in Cincinnati. "They're on the offensive and are ready to act." | BW |

(L TO R) TOM WAGNER; TOBY MELVILLE/REUTERS

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China: Where Retail Dinosaurs Are Thriving

As shoppers go upscale, sales are booming for mainland department stores



PCD's Chan: His chain's shares are up 50% since a December IPO in Hong Kong

MARK LEONG/REDUX; CHART BY ALBERTO MENA/BW

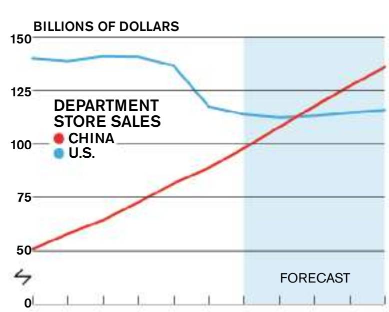
By Bruce Einhorn and Wing-Gar Cheng

Retailers in the U.S. have wistfully packed Santa off to the North Pole, but the holiday season is just beginning for Chinese department-store chain PCD. In the runup to Chinese New Year on Feb. 14, PCD is prospering: A December sale attracted so many customers that Beijing police had to step in to control traffic. "The love affair of the Chinese consumer with luxury products is growing," says PCD Chairman Alfred Chan.

Unlike most of the developed world, that affair is more often happening at the local equivalent of Macy's or Bloomingdale's. While Americans and Europeans increasingly turn to alternatives such as Wal-Mart, Carrefour, Best Buy, and Amazon, in China "there is still plenty of potential for department stores" says Yuan Fei, chief financial officer of Intime, a Beijing-based chain with 20 outlets that aims to triple in size by 2016.

That kind of growth is attracting investors. PCD raised $377 million in a Hong Kong initial public offering in December, and the stock is up 50%. Other chains are doing even better: Intime's shares have increased 320% since March, Parkson Retail Group's have more than doubled, and New World Department Store's have tripled.

SHOPPING HEAVEN



Data: Euromonitor International

Department stores in China have big competitive advantages over their Western counterparts. E-commerce has yet to take off in the mainland, and brokerage CLSA expects China's retail market to expand by 24% this year. Department stores, unlike many retailers in China, have a reputation for eschewing counterfeit goods. "People think department stores are safer," says Shaun Rein, managing director of China Market Research Group. The retailers also benefit from the growing interest in the designer names they carry. "With the emergence of the middle class, people are going for better brands," says Yuval Atsmon, an associate principal for McKinsey in Shanghai.

To reach those consumers, department stores have narrowed their scope. The most successful have stopped trying to match the prices of discounters like Wal-Mart and Chinese electronics chains such as Gome and Suning. Instead, they devote most of their space to high-margin goods such as cosmetics, clothes, and shoes. Those items now account for 70% of sales at the top department stores, Boston Consulting Group (BCG) estimates. In contrast to U.S. custom, large Chinese retailers sign deals directly with brand owners, charging them rent and letting them manage their sales in the store.

That's not to say that department stores face a trouble-free future. Foreign fast-fashion chains such as Zara and H&M are targeting China, appealing to the same young and affluent shoppers who are the department stores' core customers. And China has more than 1,000 department-store operators, a legacy of the days when practically every mainland city had its own state-owned store. "Consolidation is inevitable," says Alfred Cheng, CEO of Parkson, one of the biggest chains, with 45 stores in 29 cities. Today, the top five department store operators together have just 8% of the market, vs. 70% in the U.S., BCG estimates. That will soon change, Cheng predicts: "There will be only 10 to 15 groups remaining 10 years down the road." |BW|

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STEPHEN VOSS/BLOOMBERG

STRATEGY & COMPETITION

Legal Blogger, Prime-Time Prospect

A new TV pilot tells the tale of a valiant civil litigator battling before the Supreme Court. Honest.

By William McQuillen

Tom Goldstein has argued before the U.S. Supreme Court on behalf of shoppers who overpaid for vitamins, fellow lawyers facing court sanctions, and disabled passengers unhappy with their treatment on cruises. But he had no idea mundane legal issues might make for riveting television. "If you knew my life, you would not think it is the stuff of television drama," says the 39-year-old Goldstein, who has argued 21 cases before the Supreme Court since 1999.

Hollywood thinks otherwise. Sony Pictures Television has bought the rights to Goldstein's life story and NBC has commissioned a pilot for the series, tentatively titled *Tommy Supreme*. Past TV shows that centered on the High Court met with swift and unpleasant verdicts. But then, they didn't feature a poker-playing barrister with a social conscience to help enliven the court's often fusty proceedings.

The new series would center on a younger version of Goldstein, a partner at Akin Gump Strauss Hauer & Feld in Washington who also runs the Scotusblog.com Web site that tracks the inner workings of the High Court. (Scotus is legal shorthand for the Supreme Court of the U.S.) The hard-charging Goldstein argued his first Supreme Court case at 28—for free.

A script is being written, but actors haven't been cast. Still, Goldstein says, if the show is fast-tracked, it could find a spot on NBC as early as next fall.

TOMMY SUPREME TAKES A FEW LIBERTIES. IN IT, GOLDSTEIN'S ALTER EGO BANKROLLS HIS PRACTICE WITH POKER WINNINGS

The show's protagonist is an idealist fresh out of law school who argues Supreme Court cases. In true Hollywood fashion, he will butt heads aplenty with big companies and the government, Goldstein said.

The real-life Tommy Supreme co-chairs a litigation practice with 250 lawyers who bring in $200 million in revenue annually. His clients have ranged from medical products maker Teleflex to the Los Angeles Police Dept. And he's been named one of *GQ* magazine's 50 Most Powerful People in Washington.

Goldstein argued his first case before the U.S. Supreme Court at age 28

The show will dramatize cases that "can translate to the average worker, issues that are humanized," says Barry Schindel, a former public defender who has produced episodes of *Law & Order* and is writing the pilot's script.

The pilot is based on an actual international child abduction case handled by Goldstein's real-life wife, Amy Howe, who had been his law partner until he joined Akin Gump in 2006. The case, which the High Court heard on Jan. 12, focuses on whether a mother who took a child out of Chile against the wishes of the father (Howe's client) must return the child.

Schindel said another possible show could dramatize the court's June 2009 ruling in favor of white firefighters in New Haven, who claimed they suffered reverse discrimination. Goldstein wasn't actually involved in that case, either. But this is Hollywood.

As the show's consultant, Goldstein meets with Schindel to answer questions on how the court works and other legal matters. He realizes some accuracy may get lost for the sake of entertainment. For example, his TV alter-ego will bankroll his law practice with his winnings at the poker table. Goldstein, who has played in the World Series of Poker tournament, never did.

"There is that gap between the lawyers' world and dramas and entertainment," Goldstein said. "You have to expect that there will be added elements." |BW|

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ECONOMICS & POLICY

Indonesia: Unfinished Highway to Growth

Farmers are stalling the government's efforts at much-needed infrastructure improvements

By Daniel Ten Kate and Achmad Sukarsono
SEMARANG, INDONESIA

Construction on the six-lane highway meant to span Java, Indonesia's most populous island, comes to an end 200 yards from Nur Salim's rice paddy. While bulldozers claw through woodland and level the red earth nearby, they can't go farther until Salim agrees to sell a patch of land the size of a tennis court. "We're going to fight to the end," Salim says in the wooden, single-story home where he and his wife raised their five daughters. "We have no deadline."

The dispute highlights the obstacles facing President Susilo Bambang Yudhoyono as he tries to fix the country's roads, ports, and railways. "We have been screaming about infrastructure for years," says Iskandar Zulkarnain, president of shipping company Internusa Hasta Buana.

While campaigning for his second term last summer, Yudhoyono pledged to double spending on infrastructure, to $140 billion over the next five years. He believes that will help him boost economic growth to 7% by 2014 from an estimated 4.3% last year. During Yudhoyono's first five-year term, Indonesia built only 78 miles of expressways.

HOW TO PLAY IT 70

The Trans-Java Expressway might as well be called the Trans-Java Speedbump. The project began in 1988, but the government has yet to obtain more than half the land for the highway, which will stretch some 740 miles. Only about a quarter of it has been built, in more than 20 sections separated by miles of potholed, two-lane roads.

The problem isn't just with highways. Jakarta's Tanjung Priok port, the largest of the country's 2,000-plus seaports, will soon reach capacity. Although an expansion is due by 2013, that will do little to ease congestion once goods leave the quays. Container trucks often need a day to move the seven miles to the nearest highway. The railway from Bandung, Java's third-largest city, stops a half-mile short of the main port, so goods must be transferred to trucks to make a train connection.

As a result, produce from the Indonesian island of Borneo can cost more than double that from China, says Zaldy Ilham Masita, chairman of the Indonesia Logistics Assn. "Companies come here because they see a huge market, but they don't intend to make Indonesia a production center because of the high logistics costs," Masita says.



Salim's refusal to sell his rice paddy has blocked the six-lane Trans-Java Expressway

Plenty of companies want to help. Siemens and Alstom are interested in building a $200 million rail link from central Jakarta to its airport. General Electric sees "huge potential" for its power plants, locomotives, jet engines, and more, says David Utama, GE's Indonesia head.

Potential doesn't matter when you can't build. A 1961 law allows the president to seize land from those who refuse to sell, but no president has done that. "Can you imagine the president revoking the land of a poor owner?" asks Frans Sunito, president director of Jasa Marga, which is building the section of highway near Salim's home. A proposed law would shift the onus of seizures to the Public Works Ministry. While owners could appeal the ministry's decision, the land would be immediately transferred to the government. The measure would force Salim to sell—which he says he would do for some $38 per square meter. That's about 15% higher than his neighbors received, so officials are reluctant to make the deal. "How can they call this a negotiation?" Salim asks, puffing on a clove cigarette. "We are ready to sacrifice our land only if the price is right." |BW|

PHOTOGRAPHS BY DIMAS ARDIAN/BLOOMBERG

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MANAGEMENT & LEADERSHIP

Your Boss to Your Kids: Slim Down

HR has yanked the junk food and badgered you to get healthy. Now it's eyeing your spouse and children



Instead of ordering in, Gonzalez and her daughter cook using IBM menus

JENNIFER S. ALTMAN

By Michelle Conlin

The health nags in human resources have exhausted every possible idea to goad you into good health. At several large corporations, they've realized it's no use turning employees into vegan hardbodies if their dependents—also on the company health insurance plan—are gorging on trans fats and becoming regulars at doctors' offices.

That's why the next front in the Wellness Wars is not about you. It's about your husband, your wife, and your kids. While most big companies already have employee wellness programs, the newest trend is expanding those efforts to include dependents, says LuAnn Heinen, director of the National Business Group on Health, a Washington-based health-care think tank. If you can get your family on its corporate wellness program, Aetna will give you a $1,200 reward. JPMorgan Chase offers health coaches to family members in its plan. This month IBM started sending out cartoon-adorned plates to teach kids about portion control. At Dell, spouses get discounts on medical premiums.

INCENTIVE BACKLASH

In Washington, legislators have been working to give companies more power to tie healthy behavior to financial rewards. The Senate's health-care bill would increase the amount companies can dole out as health incentives to as much as 50% of the total premium from the current 20%. Not everyone supports the proposal. The American Heart Assn. is mounting a full-scale offensive, saying the rewards could make health care less affordable for the very people who need it the most.

Obviously, this battle is about more than slimming down and lowering blood pressure. Many policy experts believe that workplace wellness programs have great cost-cutting potential. A recent meta-analysis of existing studies by two Harvard professors published in the February issue of the journal *Health Affairs* found that for every dollar companies spend on employee wellness, medical costs fall an average of $3.27. Such savings are a big reason President Barack Obama met last spring with executives from companies such as Johnson & Johnson and Microsoft, which both say their initiatives save them millions annually.

In 2008, IBM became one of the first companies to roll out a children's health rebate. Doris Gonzalez, a senior manager in IBM's corporate citizenship department, says she was calorie counting during the workday, but when she returned home to her three-year-old, Milena, the 51-year old single mother felt wiped out. The dinner time tableau featured mother and daughter zoning out in front of the TV and ordering pizza, pasta, or fried chicken from the Dominican joint down the street. "Milena maybe watched a little bit more TV than she should have," she says.

Now Gonzalez limits takeout to twice a week and restricts TV to weekends. Mother and daughter cook dinner together from the weekly menus IBM drops into Gonzalez' in-box. Gonzalez has lost 10 pounds, Milena snacks on fruit and pita instead of gummi bears and chips, and each receives a $150 annual rebate. IBM says nearly two-thirds of the kids participating in the program have lost weight.

Jennifer Lechman, an Aetna benefits consultant, told her husband and three kids they would get a cut of the $1,200 incentive if they joined her company's program. Now the kids try to out-fruit one another. After dinner the family takes walks or jumps on the trampoline. "This outsources the management of it to them," says Lechman. "I don't have to nag." | BW |

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#1 IN WASHINGTON

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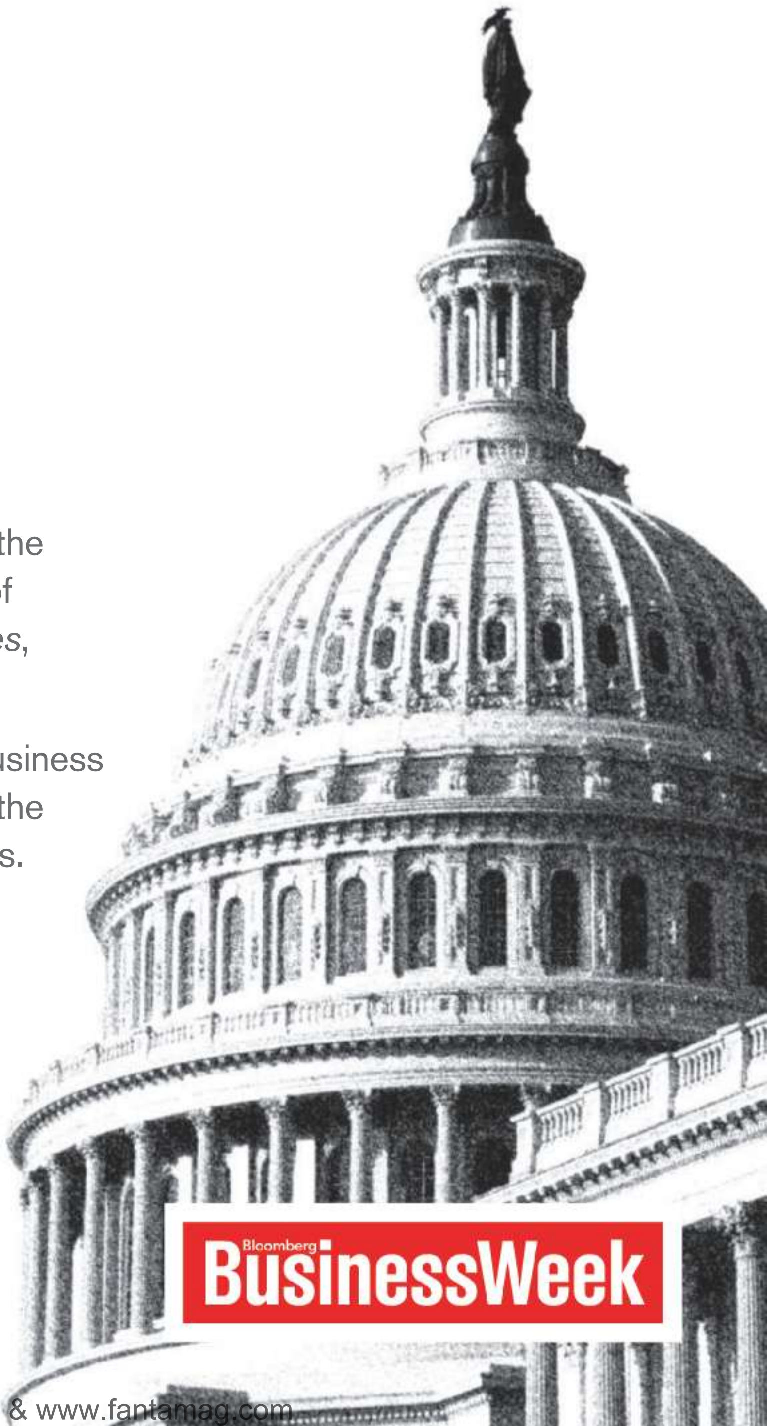
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PERSONAL BUSINESS



MONEY REPORT

CHASING A BOUNCE

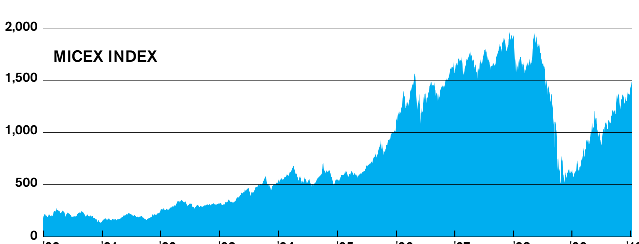
Although JPMorgan Chase beat expectations on Jan. 15, reporting net income of $3.28 billion, up from $702 million a year earlier, its shares dropped 2.3%, to 44. CEO Jamie Dimon (right) called the bank's fourth-quarter performance "a little disappointing" as fixed-income trading revenue fell from the previous three months and the bank's retail unit posted its first quarterly loss in nearly two years. Still, among 30 analysts who follow the stock, the average estimate for where shares will trade 12 months from now is nearly 55. In a report, analysts at independent firm Collins Stewart described JPMorgan's results as weaker than anticipated but said they expect the stock to reach 53 by yearend, given the bank's capital and competitive position. "The strength of the balance sheet is evident," stated the report. *–Tara Kalwarski*

EMERGING MARKETS

RUSSIA STOCKS ROCKET

Russia's MICEX Index hit a 17-month high on Jan. 18. The index of 30 large stocks is up about 8% in 2010 after rising 121% in 2009. Moscow-based UBS analyst Dmitry Vinogradov is among many Russia bulls betting the rally will continue. "Russia is the least expensive market in the global emerging-market universe despite having one of the highest earnings growth [rates]," he wrote in a Jan. 18 report. UBS estimates 2010 earnings per share for the index will grow 38%.

A low-cost way into Russian stocks is the $1.7 billion Market Vectors Russia Exchange-Traded Fund. With 42% of assets in energy as of Dec. 31, according to Morningstar, it's a commodity bet. And the new $13 million iShares MSCI Emerging Markets Eastern Europe Index has about 60% in Russia. *–Jason Corcoran*



Data: Bloomberg

BRAD TRENT; CHART BY DAVID FOSTER/BW

MUTUAL FUNDS

IT PAYS TO BE GOOD

Who says nice guys finish last? The ING Socially Responsible Investments Index, which tracks the stocks of 50 companies, returned 47.4% in 2009. That handily beat the 26.5% gain of the Standard & Poor's 500-stock index. A review of the 145 socially responsible equity mutual and exchange-traded funds tracked by Morningstar shows that 65% outperformed the S&P 500 last year.

Many socially responsible investing (SRI) funds shun alcohol, tobacco, gaming, and defense companies and embrace tech. So they have benefited from the 2009 returns of popular SRI holdings including Cisco (+46.9%), Microsoft (+60.5%), Google (+101.5%), and Intel (+43.9%). Among the SRI funds that are highly rated by Morningstar, Parnassus Workplace Fund topped the list with a 62% return last year. Over 10 years, two funds, Parnassus Equity Income and New Alternatives, gained nearly 7% a year, on average, vs. a 9% cumulative loss for the S&P 500 over the same period. *–T.K.*

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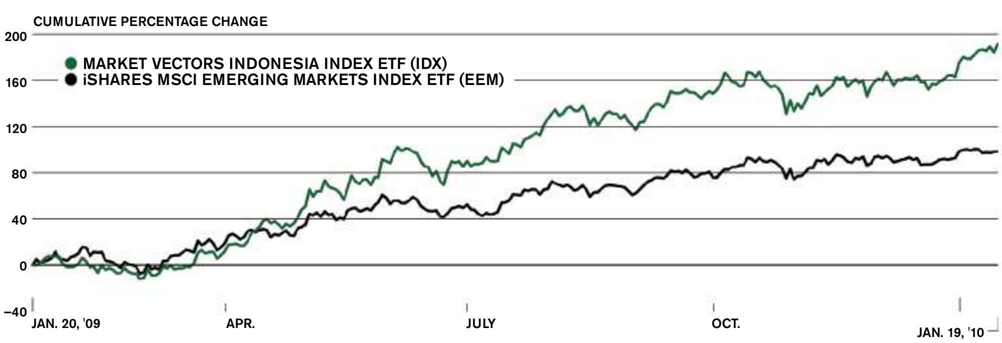
HOW TO PLAY IT | INDONESIA



(FROM PAGE 066)

By Tara Kalwarski

An infrastructure logjam has stymied the economic growth of Indonesia. But the country's gross domestic product is still expected to expand by about 5.6% in 2010, more than double the U.S. forecast of 2.7%. An exchange-traded fund (ETF) that tracks Indonesia's equity market has returned significantly more than a broad emerging-market ETF since its 2009 launch.



Data: Bloomberg

A CUT OF THE ACTION

These diversified mutual funds offer exposure to Indonesian companies.



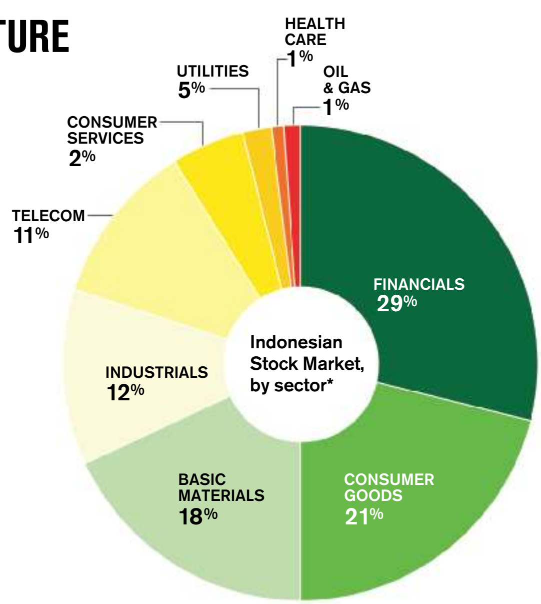




Data: Morningstar

INFRASTRUCTURE BOOM

Sectors including materials, industrials, and utilities—which make up more than a third of the stock market—stand to benefit from increased spending.



*Breakdown of Jakarta Composite as of Jan. 19
Data: Bloomberg

SLIM PICKINGS

Only two Indonesian companies are widely traded on U.S. exchanges.

INDOSAT IIT
Aerospace and Defense

One-year total return*
26%
Price $30

TELEKOMUNIKASI INDONESIA TLK
Telecom Services

One-year total return*
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Price $41

*As of Jan. 19

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PHILANTHROPY

RETHINKING HOW TO GIVE

By Amy Feldman

When disaster strikes, as it has in Haiti, Americans dig into their pockets and give. While such generosity is unquestionably a good thing in a terrible time, few individuals do much research on the groups they've chosen to receive their money. The uncomfortable truth in philanthropy is that it's not easy to know whether the group you're giving to is particularly effective at what it does. With Americans giving more than $200 billion a year, that's a lot of ambiguity.

A growing movement to review and rate charities on their real world results could give individuals a far better idea of where their donations can do the most good. Moreover, it could guide nonprofits to focus on the programs that have the most impact and to jettison those that aren't working as well.

Charity Navigator (charitynavigator.org), the largest nonprofit rater, is overhauling its rating system to look beyond financial measures and gauge effectiveness. Other online evaluative efforts include GiveWell (givewell.net), Philanthropedia (myphilanthropedia.org), and GreatNonprofits (greatnonprofits.org). Their approaches vary, from crowdsourcing to research reports. In addition, GuideStar (guidestar.org), which serves as a clearinghouse of information on nonprofits, has begun including some of these rating reports on its site. Two other initiatives, from Root Cause (rootcause.org) and Partners for Change Initiative (partners4change.org), are working to get more and better rating information to financial advisers so they can help clients make giving decisions (table, page 74).

Not all the efforts are new, but they're starting to reach critical mass. "There is a mindset shift going on in philanthropy," says Sean Stannard-Stockton, chief executive of Tactical Philanthropy Advisors (tacticalphilanthropy.com), a Burlingame (Calif.)-based advisory firm to high-net-worth donors. "People want to know that their money is actually making a difference." That's especially true in the current economic downturn: Donors have fewer funds to give, while charities need more cash to provide services to more people in need.

It may be smarter for donors to think about their giving as they would their investment portfolios. That means addressing the big questions first (what matters most to you?), then drilling down to the groups that have the most impact. "We as Americans like to do things immediately," says GuideStar President Robert Ottenhoff. But a more thoughtful way to give away money is to have a longer-term plan.

Figuring out a charity's effectiveness is not simple. A homeless shelter, international



UN PHOTO/MARCO DORMINO/ATLAS PRESS

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$229 billion

Amount U.S. individuals gave to charity in 2008

Data: GivingUSA Foundation; excludes $23 billion in charitable bequests.

In Haiti: Every penny counts because of the breadth of the disaster



relief organization, or other philanthropy is not a business, and their social impact needs to be evaluated on different criteria than profit and loss. The true benefit of their programs may not be clear for years. "Social-impact assessment is the Holy Grail of people doing philanthropy and nonprofit work," says Laura Callanan, a philanthropy expert at McKinsey. "How do you know what works and why? And how do you know that money is making a difference in people's lives?"

If average Americans look to one place for advice on giving, it's Mahwah (N.J.)-based Charity Navigator. It gives ratings—going from zero to four stars—to nearly 5,500 charities, and its site gets some 4 million page views annually. Those ratings have focused largely on financial yardsticks. For instance, it has given charities high marks for low overhead, but research now shows that metric is not as helpful as others in evaluating a nonprofit's work.

So Charity Navigator—under the direction of Ken Berger, its executive director since June 2008—is devising a system that will still go from zero to four stars but will include measures of financial strength, accountability, and effectiveness. Berger says he is planning to roll out those ratings in the spring of 2011, with additional information appearing between now and then. "The core concept is to look at this as a social investment, like a stock with a certain level of risk," he says. "So the rating we are looking to develop revolves around risk—what is the level of risk that you as a donor are willing to take on?" A small startup charity, for example, may have a more innovative but less proven—and thus riskier—approach to a problem than a larger, more staid organization.

To measure effectiveness, Berger says Charity Navigator's advisory panel is considering the use of crowdsourcing—gathering data through some type of Wiki format. Another possibility: David Hunter, a philanthropic consultant, has created a social-assessment tool that uses 26 questions to get at issues of how a charity gathers data on its initiatives and whether it is using that data strategically—for example, to better its programs. "I believe it not only provides a reasonable statement of the level of risk that a social investor takes, but it also should provide an organization with a diagnosis to improve its work," he says.

Charity Navigator's competitors have come up with alternative methods. Brooklyn-based GiveWell, launched in 2007, offers rigorous Wall Street-like research on nearly 400 charities. Its analysts plow through data and write lengthy, footnoted reports about each one. Few nonprofits have enough data or analysis to demonstrate their successes, and GiveWell recommends only those that can meet that high bar. "The charity needs to do a lot of analysis on its own," says GiveWell co-founder Holden Karnofsky. The upshot: GiveWell recommends just nine charities. Among them are Village Reach, which aims to improve the logistics of distributing medical supplies in rural Africa; Stop TB Partnership, which works to increase access to tuberculosis treatment; and the Nurse-Family Partnership, which supports programs that offer home visits by registered nurses to low-income, first-time mothers.

NONPROFIT PORTFOLIOS

Root Cause, based in Cambridge, Mass., has recently begun creating similar research reports with financial advisers in mind. Its first batch covers educational groups (specifically, those focused on school readiness) in Massachusetts. Palo Alto (Calif.)-based GreatNonprofits, started in 2007, allows donors, volunteers, and social-service recipients to write reviews à la TripAdvisor or Yelp; it currently has reviews of some 3,000 nonprofits. The opinions are also available on GuideStar. Perla Ni founded GreatNonprofits in the wake of Hurricane Katrina, when people kept asking her where to give. "People who are served by nonprofits know which ones are good and which ones are not," says Ni. "It's like asking people who stayed at a hotel to write a review."

Two groups have taken yet another route:

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LIFE MANAGEMENT

creating portfolios of nonprofits. Recently launched Philanthropedia, based in Menlo Park, Calif., gathers the opinions of experts in different sectors and creates what it calls "expert mutual funds." These are portfolios of nonprofits in areas such as climate change, microfinance, and education, with a dozen or so "holdings" in each. To put together its climate change fund, for example, Philanthropedia queried 139 experts, including funders, nonprofit executives, and academics. Top holdings include the Natural Resources Defense Council, the Union of Concerned Scientists, the World Resources Institute, and the Pew Center on Global Climate Change. "A lot of the other approaches [to rating nonprofits] ask too much of donors," says Philanthropedia Chief Executive Deyan Vitanov.

Partners for Change, based in Chicago, is also working up a mutual fund-like strategy. Its portfolios, which it will share with financial advisers, will mimic those of successful foundations. So a donor interested in global health might be able to invest in a portfolio that looks a lot like the Gates Foundation's beneficiaries. Executive Director Jim Litwin expects to launch the system in the summer. He hopes that by targeting advisers rather than individuals, he'll be able to reach donors with $10,000 or more to give. As Litwin says: "These foundations have already done all the work on what the most effective organizations are, so why can't you leverage that knowledge of where to give?"

For individual donors, all of this information could help in better decision-making. For the field of philanthropy, it could have far-reaching implications. The hope is that if nonprofits know their programs aren't working well, they will revamp them. Also, if more of the $200 billion in annual donations ends up going to the most effective charities, it could push others to combine forces. "We're starting to see a shakeout," says Nancy Kelly, an accountant to nonprofit organizations at the Metis Group, a New York City-based accounting and business consulting firm. "You're seeing more competition for dollars and more merger activity than in the past 15 years. It is forcing nonprofits to look at their operations like a business." |BW|

ANALYTICAL GIFTS

Seven groups with different approaches to evaluating philanthropies

GROUP/WEB SITE	APPROACH
Charity Navigator charitynavigator.org	The biggest of the charity ratings groups, it looks at 5,500 organizations. Its current four-star system is based largely on financial criteria; a pending overhaul, expected to be launched in 2011, will add information on social effectiveness.
GiveWell givewell.net	GiveWell offers detailed, equity research-like reports on nearly 400 nonprofits. It recommends just nine that pass its strict criteria.
GreatNonprofits greatnonprofits.org	GreatNonprofits, launched after Hurricane Katrina, gauges nonprofits through crowdsourcing. It allows clients, volunteers, and funders of nonprofits to post reviews based on their personal experiences.
GuideStar guidestar.org	GuideStar acts as a clearinghouse of information on nonprofits, with data from the Form 990 tax forms these groups must file as well as the reviews of GreatNonprofits.
Partners for Change partners4change.org	This new initiative aims to get research on nonprofits into the hands of financial advisers and their clients who give away at least $10,000 a year. The idea: to make it easy for individuals to mimic the portfolios of well-run foundations.
Philanthropedia myphilanthropedia.org	This recently launched effort asks experts for their opinions on social causes, such as education and Bay Area homelessness, and then uses the answers to create "expert mutual funds" with a dozen or so organizations or "holdings."
Root Cause rootcause.org	Root Cause's new research targets financial advisers with reports on nonprofits. Its first test series of reports was on school-readiness organizations.

Data: *Bloomberg BusinessWeek*

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INVESTING

MERGERS

GETTING IN ON M&A ACTION

By Tara Kalwarski

Anyone seeking green shoots in this economy should look at global M&A, where you can actually spot a few saplings. The value of deals in November hit $323 billion, the highest monthly tally since July 2008. Five deals valued at more than $10 billion, including Novartis' bid for Alcon this month, have been announced since December.

Dealmaking will be driven by cash-rich companies looking for bottom-line growth, rather than private equity firms, which still face a challenging financing environment, says Bob Filek, partner with PricewaterhouseCoopers Transaction Services in Chicago. These corporate hookups are the bread and butter of merger arbitrage mutual funds, which have seen total assets nearly double in size over the past year. "The driver of this wave of mergers is global growth, and it's happening now," says Mario Gabelli, CEO of GAMCO Investors in Rye, N.Y.



THOMAS POROSTOCKY

For all the seeming sexiness of dealmaking, Gabelli, who manages two merger arbitrage mutual funds, says the strategy is like "watching grass grow." It involves buying shares of target companies after a deal has been announced and profiting off the spread, or the difference between the target company's stock price and the price offered by the acquirer. The stock of the target will usually jump on news of the bid, but the risk that a deal might unravel leaves shares trading at a discount to the offer price—a discount usually equal to the interest rate on short-term Treasuries, plus a little more, to pay investors for taking a chance. Merger arbitrageurs buy after the announcement and wait for that discount to turn into a gain once the deal is complete. (If a deal is financed with stock, some managers short the acquirer's shares to lock in a spread.)

8%

The Merger Fund's average annual return since its inception in 1989. That compares with 9% for the S&P 500.

Data: Morningstar

There are good arguments for investing in these types of funds now. Again, the thrill of the chase isn't one of them: Typically, these funds don't return much more than five percentage points or so above short-term Treasuries. Last year, most returned less than 10%, vs. the 26% gain for the Standard & Poor's 500-stock index. But losses are minimal: In 2008 few funds lost more than 3%. Because of such low volatility, and since these funds don't necessarily move with the stock market, "a lot of people use arbitrage strategies as a fixed-income replacement," says Morningstar analyst Nadia Papagiannis. Since the life of an M&A deal doesn't usually run longer than four months, the funds have high turnover rates, meaning their stock holdings rotate in and out at a fast pace. "They're not very tax-efficient," says Papagiannis. She advises investors to buy these funds through tax-deferred accounts such as IRAs or 401(k) plans.

RISING RATES, RISING RETURNS

The 20-year-old, $2.3 billion Merger Fund has returned an average of 8% a year and lost money only twice. Co-manager Michael Shannon says rising interest rates expected over the next year or so will help boost returns. When capital costs rise, he explains, the spread gets wider because it is based on short-term rates.

The Gabelli ABC Fund, which has had one losing year out of 15, is the cheapest of the funds. The annual cost to fundholders, expressed as a percentage of assets, is 0.64%. It is the only merger arb offering to get Morningstar's five-star rating. The four-star—and more costly, at 1.86%—Gabelli Enterprise Mergers & Acquisitions Fund differs by investing in rumored as well as announced deals. Returns can be volatile: down 27% in 2008, up 25% in 2009.

The newest player: IQ ARB Merger Arbitrage Exchange-Traded Fund, launched in late 2009, with assets of $6 million. Index IQ CEO Adam Patti says its diminutive size is an advantage: "We can look at much smaller deals." At 0.75%, its costs are among the smallest, too. | BW |

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BUSINESS VIEWS

BOOKS By PETER COY

Why the Price Is Rarely Right

Consumers think they know what something is worth, but sellers have evolutionary advantages

You are hopelessly gullible. You have no firm idea of what anything should cost, so advertisers, marketers, and salespeople regularly lead you astray. If you're sure that you're too smart for their pricing tricks, that makes you dumber still, because you don't even realize you're being exploited.

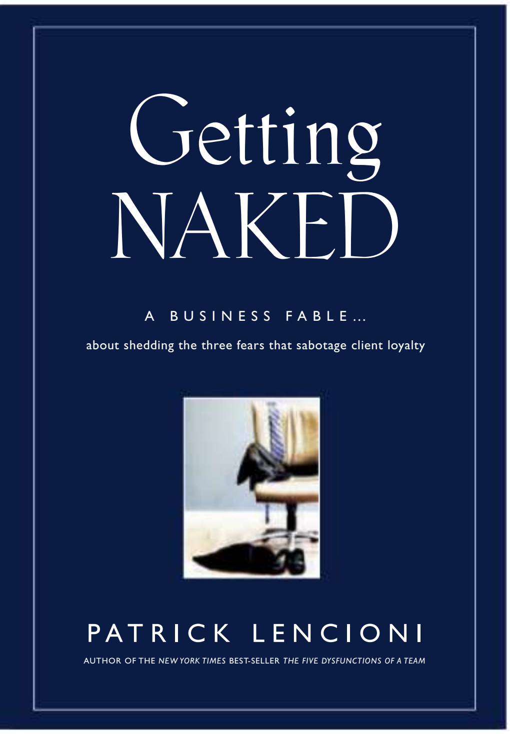


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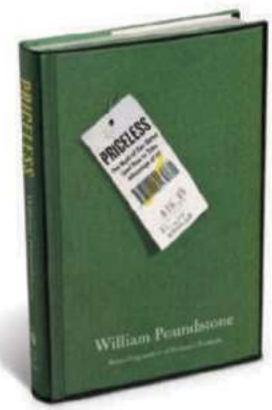
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BOOKS

That's pretty much the message of William Poundstone's *Priceless: The Myth of Fair Value (and How to Take Advantage of It)*. Poundstone, a Los Angeles-based author of 11 nonfiction books, isn't indignant about all the obstacles to value. He's intrigued. For him, prices are fascinating because they sit squarely at the intersection of our desires and the objects of desire. What we're willing to pay reveals much about the chaos inside our skulls.



In Econ 101, price is a clean concept. People know how much various things are worth to them, and they line up those personal valuations against what sellers are asking. In reality, writes Poundstone, "the numbers that make our world go around are not so solid, immutable, and logically grounded as they appear. In the new psychology of price, values are slippery and contingent, as fluid as the reflections in a fun-house mirror."

People's cluelessness about what goods are worth to them makes them vulnerable to what behavioral economists call "anchoring." As every luxury retailer knows, an anchor is a high-priced product that may never sell but "makes everything else look affordable by comparison." Poundstone observes that in the midst of the recession, Ralph Lauren was selling a "Ricky" alligator bag for $14,000. (Update: It's now $16,995, making Lauren's Tiffin Bag a steal at just $2,595.) And anchoring works: Williams-Sonoma once offered a fancy breadmaker for $279. Then it added a $429 model. The costly model flopped, but sales of the cheaper one doubled.

Poundstone's publishers make amusing use of anchoring right on the dust jacket of *Priceless*. The book's title is printed on a price tag that appears to be attached to the cover. The tag says the original price of the book was $559.99. Not true, but even so, the sky-high number somehow reflects well on the book's actual price—$26.99. Well played, jacket designer.

The power of anchoring explains everything from why plaintiffs' lawyers often demand ridiculous sums for pain and suffering (the more you ask, the more you get) to bubbles in the stock market (investors become anchored to high and rising prices no matter how out of line with fundamentals).

Poundstone is far from the first to spot and write about pricing tricks, some of which are centuries old. Recently we have seen a spate of books by pioneers of behavioral economics such as Richard Thaler and Dan Ariely, both of whom Poundstone liberally quotes. Where he excels is in explaining why age-old pricing tricks work long after we should have wised up. Citing psychological research, he says the human brain evolved for success in a world blessedly free of teaser rates, rebate coupons, and late-night infomercials. Optimized for quick decision-making, the brain "constructs desires and beliefs on the fly," writes Poundstone. "This," he says, "can lead to inconsistent prices and choices" that are ripe for exploitation.

***Priceless: The Myth of Fair Value (and How to Take Advantage of It)* by William Poundstone; Hill and Wang; 352 pp; $26.99**

Aside from his main counsel—know your limitations—Poundstone sprinkles *Priceless* with bits of consumer advice, like: Be the first to name a price in a negotiation, and don't worry about being overly reasonable. Also: To neutralize the effect of anchoring on your judgment, stop and think of all the reasons that the proffered price might be unreasonable.

Pricing is a richer subject than you might imagine. The smile that creeps onto your face when a shameless marketing gambit reminds you of something you read in Poundstone's book? Priceless. | BW |

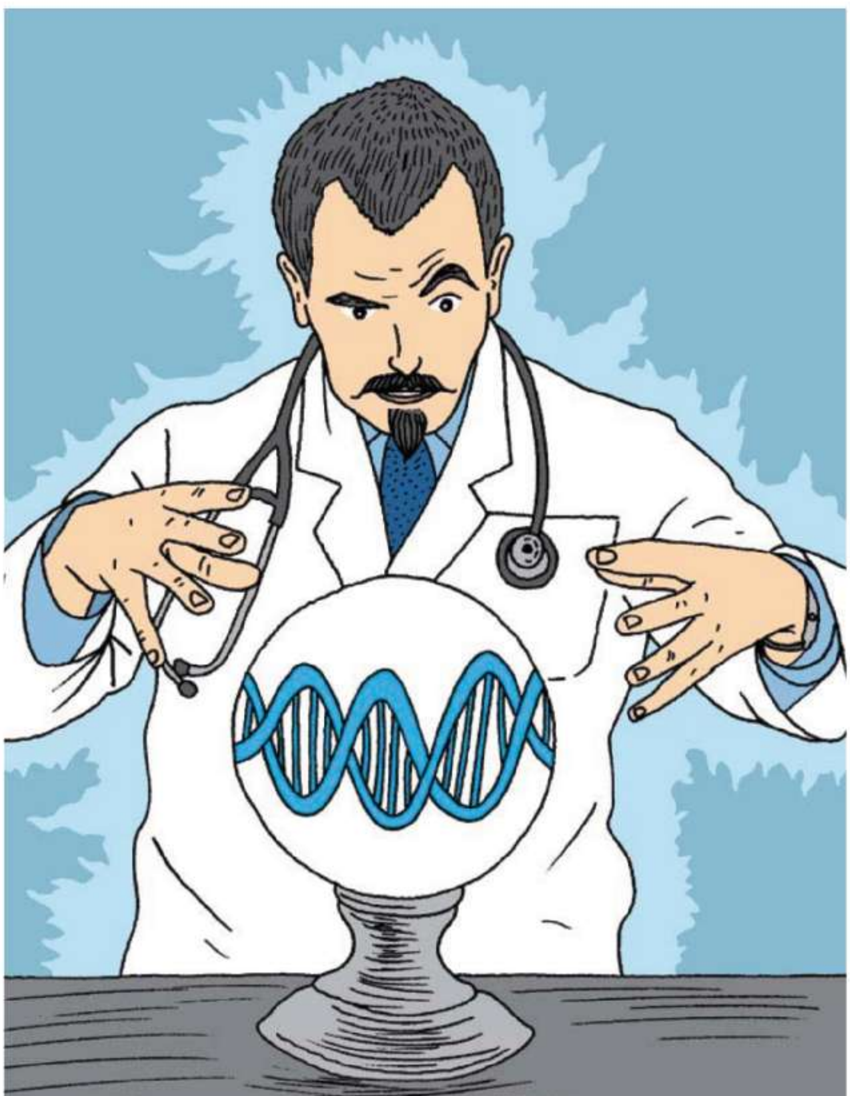
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TECH & YOU

By RICH JAROSLOVSKY

Self-Absorbed? It Must Be My Genes

Web services offering consumer DNA tests are easy to use, sometimes edifying, and endlessly entertaining



PETER ARKLE

I have fascinating genes. At least, they're fascinating to me. For the last several weeks I've been getting up close and personal with my DNA as I compared three major direct-to-consumer genetic testing services. These companies, which claim to identify their customers' genetic predispositions for various diseases, are products of the multibillion-dollar, multiyear effort to map the human genome. It's a place where biotech meets infotech.

To test the services, I signed up for all three—Navigenics, 23andMe, and deCODEme—at the same time. Once I registered and paid online, each service sent me a kit to collect my genetic material and a mailer to return it. Navigenics and 23andMe use saliva samples for analysis. DeCODEme has a more involved process, using what looks like a specialized tongue depressor to take a scraping of the inside of your cheek. I was a bit worried about messing things up, but a video on the Web site showed me how to do it properly. To measure response times, I made sure to send back the kits simultaneously.

All three services make results available on password-protected Web sites, along with tools and resources to help interpret them. Navigenics' results focus solely on health and medical aspects; 23andMe and deCODEme both provide ancestry-related information as well. Of the three, the $999 Navigenics service was generally the speediest and did the best job of keeping me posted on the process. Its kit arrived in a week, and my results were ready 11 days after I returned it.

TIPS TO AVOID RISKS

Navigenics covers 27 medical conditions, from brain aneurysms to psoriasis. They're displayed on an easy-to-understand color-coded grid, with orange boxes identifying conditions that may require attention. Clicking on any box plunges you deeper into the results, bringing up detailed explanations of the disease "markers" observed in your genes, tips to mitigate your risk through controlling nongenetic factors, and links to

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support groups and other resources on the Web. Navigenics also provides a toll-free number for you to discuss your results with one of its licensed genetic counselors. The one I spoke with was excellent. And there are tips and tools for sharing results with your doctor.

23andMe, which counts Google as an investor, was the slowest of the three to report. While the $499 test kit arrived four days after I placed my order, it took 18 days for the company to acknowledge receiving my sample, and another 17 days before it posted results. In between I filled out 30 or so simple surveys 23andMe uses for its own research.

Offsetting the long wait, 23andMe was the cheapest of the three services. And it provided the most interesting (if not necessarily important) information about my results, plus social networking features and other fun stuff.

My results were presented in the form of "clinical reports," as the service calls them, covering 48 diseases, traits, and conditions where the science is pretty well-established. The service also threw in some other "research reports" that are of interest but not meant to be conclusive. The site does a good job of explaining the results, and genetics junkies can dive deeply into how their risks were assessed. Here is also where I learned that only about four pounds of my extra body weight can be blamed on genetics; the other 20 or so pounds are all me.

MEMBERS OF 23andME CAN MESSAGE ONE ANOTHER AND COMPARE GENE DATA OR FAMILY HISTORIES

Unlike Navigenics, 23andMe provides ancestry information, locating you within ethnic and geographic groupings. It also can scour its database to come up with a list of potential relatives—in my case, nearly 1,000 of them, ranging from a possible second cousin to others far more distant. Members can message one another—with or without names—and compare genomes or family histories.

GENE TESTING: ONE USER'S EXPERIENCE

	Navigenics	23andMe	deCODEme
Cost	$999	$499	$985
Test kit	arrived in 7 days	4 days	11 days
Results	arrived in 11 days	35 days	22 days
Comments	Fastest service, best communication, live access to genetic counselors	Fun social-networking features, provides ancestry info as well as health data	Good social-networking and health data, but there's a lot of red tape

RESULTS IN PERSPECTIVE

DeCODEme comes from DeCode Genetics, a company in Reykjavik, Iceland, that filed for bankruptcy protection in the U.S. just as I was signing up for the $985 service. Its kit was the last of the three to be delivered, 11 days after my order. Results were available 22 days later, but only sort of: On the site, every item I clicked on returned a message that "You cannot view further details until a health care provider has reviewed your results." A customer-service representative explained that the service needed a letter from my doctor stating that he was prepared to discuss the findings with me. She pointed me to deCODEme's terms of service. It turns out New Jersey, where I live, is listed as one of 11 states requiring that "a qualified health care professional is involved in the ordering and the delivery of results." The other two services didn't make me go through this rigmarole.

Even after I provided the doctor's note, deCODEme required me to consent item by item before showing me results on 48 different health matters. And I still couldn't get directly to my results; a pop-up window encouraged me to answer several optional questions for research purposes first. Once I finally waded through everything, deCODEme provided an impressive volume of background information to put my health results in perspective. But I found the ancestry information confusing and generic, compared with 23andMe's. The best part was a Facebook-like friend function, where I could troll for and invite other deCODEme users to share information. I felt a little like a DNA stalker.

The findings of the three services, which generally agreed with one other, are undoubtedly more interesting to me than to you. Among things I found out: While Type 2 diabetes runs on both sides of my family, I actually have less of a genetic risk than most people. On the other hand, I have slightly greater odds of developing glaucoma, though there's no family history of it. And, according to 23andMe, I metabolize caffeine faster than most people, which explains why my four-shot Starbucks cappuccinos don't send me rocketing through the ceiling.

If you're thinking there's something just a bit narcissistic in all this, you're right. So enough about me—let's talk about me. |BW|

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FEEDBACK

AUTOS

VW: YOU CALL THIS CUSTOMER SERVICE?

I couldn't stop laughing at "The Transformer: Why VW Is the Car Giant to Watch" (In Depth, Jan. 25). Volkswagen may conquer the world, but it's doing everything in its power to lose in America.

Last October I visited a local dealership. I told a nice salesman I was looking for a new Golf TDI. He said they wouldn't be out until mid-November, but he would call me. No call. Ever.

Last week I went back. No one greeted me, the cars had huge markups, and I couldn't find a TDI. Finally I caught a salesman. Once he heard I was interested in a TDI, he became arrogant. They had sold all their allotment. But he would sell me (but not let me test-drive) the one they had coming in February. I walked out. I am Volkswagen's ideal customer, yet I will never set foot in another VW dealership.

David Weber
SAN MATEO, CALIF.

"One Man, One Car, One World" (In Depth, Jan. 25) missed the point. Ford is taking the tack "If you can't join them, beat them," creating a niche and letting the Civic and Corolla fight for the Wal-Mart crowd. Consumers desiring high-tech products without the Playskool interior theme of the Mini can have differentiators



such as a dual-clutch transmission, ergonomic cockpit, and driving performance. Time will tell if this strategy of innovation works.

Lee Gilbert
NUTLEY, N.J.

ECONOMIC POLICY

WHO REALLY RATES THE THIRD DEGREE

Regarding "The Crisis Commission's Missing Witness" (New Business, Jan. 25): The missing witnesses are politicians. Let's get Barney Frank, Chris Dodd, and executives from Fannie Mae and Freddie Mac to explain why they lowered lending standards so that any warm body could get a mortgage. Better, ask Barack Obama why the federal government continues to take the position that big banks shouldn't fail. Easy money leads to bubbles, but only politicians' incompetence brings disasters like the Great Depression and its recent sequel.

Dick Patterson
EL CERRITO, CALIF.

ENERGY

FIGHTING OIL'S EVENTUAL DEMISE

"Endless Oil" (In Depth, Jan. 18) raises several questions. I agree there will still be oil discoveries, and old fields can add substantially to our reserves with innovative technology. Yet the fact remains: Petroleum is a finite resource, and one day it will be exhausted.

The article's author could have noted that new finds based on innovative technology buy more time to develop alternative energy. At the rate we are achieving alternative energy sources, it looks like we need more time. So far, the progress made with wind and hydro represents old technology. Biofuels rely on thousand-year-old crops (corn and sugarcane) and fermentation technology. Cellulosic biofuels are still not competitive. More research must be done, and the extra time new finds allow is welcome. Yet even with new finds, time is critical for development of sustainable alternatives.

Gale A. Buchanan
Former USDA Chief Scientist and Under Secretary of Agriculture for Research, Education & Economics
TIFTON, GA.

CORRECTIONS & CLARIFICATIONS

In "The Transformer: Why VW Is the Car Giant to Watch" (In Depth, Jan. 25), numbers from IHS Global Insight showed Volkswagen had produced more cars than Toyota through November 2009. Global Insight later revised the numbers to show that Toyota still had the lead in production. The story also said in one reference that Volkswagen offers 10 models in the U.S. and 8 models in another; 10 is correct.

"The Next Big Thing, 20 Years Later" (New Business, Jan. 25) incorrectly identified one of the tablets as the Motion Computing M1200. Pictured was the Acer TravelMate 100.

"How to Play It" (Personal Business, Jan. 11) did not note that Third Avenue Focused Credit Fund manager Jeff Gay's opinion about a Swift Transportation secured loan was based in part on the fact that in late September the company negotiated an amendment with lenders to avoid violating bank covenants.

"Kraft's Sugar Rush" (In Depth, Jan. 25) reported Kraft Foods' sales and earnings based on generally accepted accounting principles. However, using Kraft's preferred accounting measures, growth in "organic net revenue" was 2% through the first nine months of 2009 and growth in "earnings per share from continuing operations" was 37%.

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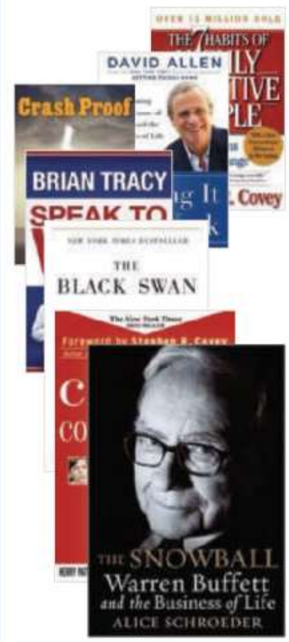
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OUTSIDE SHOT

By JOHN LEE

Don't Underestimate India's Consumers

Western multinationals are often attracted to China's size, but they're bypassing Asia's true shopping powerhouse



ILLUSTRATION BY JESSE LEFKOWITZ

The scale of China has always fascinated merchants. In 19th century England, spinning-mill owners were convinced they would reap profits beyond their dreams if they could just get every Chinese to buy one handkerchief. Alas, the one man one handkerchief plan never took, and for multinationals hoping to tap China's masses, the country continues to disappoint. Since the global economic crisis, Beijing has constructed a way around a slump. Roads, ports, railways: Name it, and China is likely building it. But its consumers aren't pitching in. As a percentage of gross domestic product, Chinese consumption is the lowest of any major economy, at less than one-third. Almost all the country's growth this year has come from infrastructure spending or speculation in domestic assets.

Western multinationals should consider fantasizing about India instead. The momentum for its bounceback comes from Indians, including the poor, buying their way to growth. The demand for handbags, air travel, and fine dining in Mumbai may have eased, but domestic consumption accounts for two-thirds of the Indian economy, twice China's level.

China's problem is that its top-down, state-led model of development (not to mention its artificial suppression of the yuan) structurally impairs domestic spending. According to Minxin Pei, director of the Keck Center for International & Strategic Studies, three-quarters of China's capital goes to 120,000-odd state-controlled entities and their many subsidiaries, leaving 40 million-plus privately owned businesses to fight for scraps. The upshot: Business profits tend to end up in state coffers, not Chinese wallets. Wage and income growth, even for China's urban residents, hovers at about half the level of GDP growth over the past 15 years.

India's bottom-up private sector model, for all its chaos and bureaucracy, provides a stark contrast. While the nation badly needs infrastructure, its consumers are in a far better position to spend. India can now boast of an overwhelmingly independent middle class about 300 million strong, vs. China's 100 million to 200 million, depending on the parameters. Profits from India's businesses, large and small, go into Indian pockets rather than the state's.

The contrast sharpens outside these two nations' cities. Half of China and two-thirds of India live in rural areas. That's about 700 million people in each. The rural half of China is falling behind. Back in the mid-1980s, the mainland's urban-rural income ratio was 1.8. It now stands at about 3.5. Although per-capita incomes have risen, an estimated 400 million mainly rural residents have seen net income stall or decline over the past decade. Yasheng Huang, a professor at the Massachusetts Institute of Technology's Sloan School of Management, estimates that China's absolute levels of poverty and illiteracy have doubled since 2000.

In India, they've been halved. The urban-rural income gap has steadily declined since the early '90s. Over the past decade, economic growth in rural India has outpaced growth in urban areas by almost 40%. Rural India now accounts for half the country's GDP, up from 41% in 1982. World Bank studies show that rural China accounts for only a third of GDP and generates just 15% of China's growth. Meanwhile, rural India is chipping in about two-thirds of overall growth.

Jagmohan S. Raju of the University of Pennsylvania's Wharton School points out that every major Indian consumer company knows it can't succeed without reaching the villages. That's why Indian companies arguably lead the world in innovative low-income products. Telecom provider Bharti offers the world's lowest call rates; Tata Motors sells the world's cheapest car. And the push for the villages has led to a well-developed consumer marketplace throughout India.

For Western brands chasing the luxury market, both China and India offer abundant opportunities. But when what you sell is suited to—and scaled to—millions of city and country dwellers, it makes sense to aim your efforts at India, at least for now. |BW|

John Lee is a fellow at Australia's Center for Independent Studies, a visiting fellow at Washington's Hudson Institute, and the author of Will China Fail?

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